



ESI Entertainment Systems Inc.

ESI ENTERTAINMENT SYSTEMS INC.

Condensed Consolidated Interim Financial Statements

For The Three and Six Months Ending August 31, 2011 and 2010.

Unaudited – expressed in Canadian dollars

ESI ENTERTAINMENT SYSTEMS INC.
Condensed Consolidated Interim Financial Statements
For The Three and Six Months Ending August 31, 2011 and 2010.
(Unaudited – expressed in Canadian dollars)

Notice to National Instrument 51-102

Condensed Consolidated Interim Statements of Financial Position	1
Condensed Consolidated Interim Statements of Loss and Comprehensive Loss	2
Condensed Consolidated Interim Statements of Changes in Equity	3
Condensed Consolidated Interim Statements of Cash Flows	4
Notes to the Condensed Consolidated Interim Financial Statements	5

Notice to National Instrument 51-102

The accompanying unaudited condensed consolidated interim financial statements have been prepared by management and have not been independently audited or reviewed by the auditor of ESI Entertainment Systems Inc.

ESI ENTERTAINMENT SYSTEMS INC.

Condensed Consolidated Interim Statements of Financial Position
As at August 31, 2011, February 28, 2011, and March 1, 2010
(Unaudited – expressed in Canadian dollars)

	August 31, 2011	February 28, 2011 (Note 20)	March 1, 2010 (Note 20)
Assets			
Cash and cash equivalents	\$ 318,476	\$ 17,742	\$ 89,208
Accounts receivable	181,705	210,160	361,745
Prepays and other	70,419	66,912	65,658
Citadel processing accounts (Note 5)	4,672,451	4,277,252	4,937,401
Current Assets	5,243,051	4,572,066	5,454,012
Capitalized Development Costs (Note 6)	144,125	160,255	47,532
Property and equipment (Note 7)	107,327	123,002	170,499
Deferred contract costs (Note 8)	368,146	382,682	550,362
Total Assets	\$ 5,862,649	\$ 5,238,005	\$ 6,222,405
Liabilities			
Accounts payable and accrued liabilities	\$ 1,594,983	\$ 2,085,028	\$ 1,516,100
Loan Payable (Note 9)	2,126,902	2,081,567	2,174,733
Citadel Processing Liabilities (Note 5)	6,042,762	5,321,142	5,649,239
Deferred Revenue	417,393	485,367	582,230
Current Liabilities	10,182,040	9,973,104	9,922,302
Deferred Revenue	446,742	519,494	913,605
Total Liabilities	\$ 10,628,782	\$ 10,492,598	\$ 10,835,907
Equity			
Share Capital (Note 10a)	9,957,969	9,957,969	9,957,969
Contributed Surplus (Note 10c)	4,589,882	4,599,296	4,500,536
Other Comprehensive Income (Loss)	(69,024)	23,318	-
Deficit	(19,244,960)	(19,835,176)	(19,072,007)
Total Equity	\$ (4,766,133)	\$ (5,254,593)	\$ (4,613,502)
Total liabilities and equity	\$ 5,862,649	\$ 5,238,005	\$ 6,222,405

Nature and continuance of operations (Note 1)

Commitments and contingencies (Note 14)

Economic dependence (Note 18)

The accompanying notes are an integral part of these condensed consolidated interim financial statements.

ESI ENTERTAINMENT SYSTEMS INC.

Condensed Consolidated Interim Statements of Loss and Comprehensive Loss
For The Three and Six Months Ending August 31, 2011 and 2010.
(Unaudited – expressed in Canadian dollars)

	Three Months Ended August 31,		Six Months Ended August 31,	
	2011	2010 (Note 20)	2011	2010 (Note 20)
Continuing Operations				
Revenues (Note 12a)	\$ 895,878	\$ 822,029	\$ 1,838,739	\$ 1,565,294
Direct Costs (Note 17)	(18,291)	482,599	790,898	980,012
Gross Profit	914,169	339,430	1,047,841	585,282
General and administration expenses (Note 12,17)	66,611	724,105	418,277	1,427,882
Income (loss) before under noted items	847,558	(384,675)	629,564	(842,600)
Other expenses (income)				
Foreign exchange (gain) loss	(160,973)	(94,250)	(22,850)	(186,659)
Tax expense	(562)		(562)	
Interest income	-	(645)	(10)	(689)
Interest expense	31,505	53,223	62,770	101,930
Income (loss) for period attributable to equity holders	977,588	(343,003)	590,216	(757,182)
Other comprehensive income				
Foreign currency translation gain (loss)	(88,429)	64,276	(69,024)	64,276
Total Comprehensive income (loss) for the period attributable to equity holders	\$ 889,159	\$ (278,727)	\$ 521,192	\$ (692,906)
Basic and diluted loss per share (Note 11)	\$ 0.06	\$ (0.02)	\$ 0.04	\$ (0.05)

The accompanying notes are an integral part of these condensed consolidated interim financial statements.

ESI ENTERTAINMENT SYSTEMS INC.

Condensed Consolidated Interim Statements of Changes in Equity
(Unaudited – expressed in Canadian dollars)

	Number of shares (Note 10,20)	Share capital (Note 10,20)	Contributed Surplus (Note 10,20)	Other Comprehensive Income (Loss) (Note 20)	Deficit (Note 20)	Total equity
Balance, March 1, 2010	14,234,727	\$ 9,957,969	\$ 4,500,536	\$ -	\$ (19,072,007)	\$ (4,613,502)
Share-based compensation	-	-	450	-	-	450
Foreign currency translation differences for foreign operations	-	-	-	64,276	-	64,276
Profit (loss) from continuing operations attributable to the equity holders	-	-	-	-	(762,950)	(762,950)
Balance, August 31, 2010	14,234,727	\$ 9,957,969	\$ 4,500,986	\$ 64,276	\$ (19,834,957)	\$ (5,311,726)
Share-based compensation	-	-	98,310	-	-	98,310
Foreign currency translation differences for foreign operations	-	-	-	(40,958)	-	(40,958)
Profit (loss) from continuing operations attributable to the equity holders	-	-	-	-	(219)	(219)
Balance, February 28, 2011	14,234,727	9,957,969	4,599,296	\$ 23,318	\$ (19,835,176)	\$ (5,254,593)
Share-based compensation	-	-	(9,414)	-	-	(9,414)
Foreign currency translation differences for foreign operations	-	-	-	(92,342)	-	(92,342)
Profit (loss) from continuing operations attributable to the equity holders	-	-	--	-	590,216	590,216
Balance, August 31, 2011	14,234,727	\$ 9,957,969	\$ 4,589,882	\$ (69,024)	\$ (19,244,960)	\$ (4,766,133)

The accompanying notes are an integral part of these condensed consolidated interim financial statements.

ESI ENTERTAINMENT SYSTEMS INC.

Condensed Consolidated Interim Statements of Cash Flows
For the Three and Six Months Ending August 31, 2011 and 2010.
(Unaudited – expressed in Canadian dollars)

	Three Months Ending August 31		Six Months Ending August 31	
	2011	2010	2011	2010
Cash provided by (used for) the following activities				
Operating activities				
Income (Loss) for the period	\$ 889,159	\$ (278,727)	\$ 521,192	\$ (692,906)
Add (deduct)				
Depreciation	22,086	12,370	41,578	26,345
Stock-based compensation	(29,416)	(4,697)	(9,414)	(5,318)
	881,829	(271,054)	553,356	(671,879)
Changes in non-cash working capital:				
Accounts receivable	(98,994)	(149,495)	28,455	(201,069)
Prepays	20,106	(6,114)	(3,507)	(38,332)
Accounts payable and accrued liabilities	(715,575)	546,693	(538,322)	1,061,088
Deferred revenue	(179,608)	(251,903)	(140,726)	(225,866)
Deferred contract costs	10,317	53,663	14,536	83,448
Cash flow (used in) from operations	(81,925)	(78,210)	(86,208)	7,390
Investment activities				
Capitalized development costs	8,182	(71,801)	24,792	(71,801)
Acquisition of property and equipment	(4,179)	(3,218)	(9,606)	(3,218)
Cash from (used in) investing activities	4,003	(75,019)	15,186	(75,019)
Financing activities				
Loan payable	20,880	72,247	45,335	73,215
Change in Citadel processing liabilities	361,161	-	721,620	-
Change in Citadel processing assets	(392,016)	-	(395,199)	-
Cash from (used in) financing activities	(9,975)	72,247	371,756	73,215
Increase (decrease) in cash and cash equivalents	(87,897)	(80,982)	300,734	5,586
Cash and cash equivalents, beginning of period	406,373	175,776	17,742	89,208
Cash and cash equivalents, end of period	\$ 318,476	\$ 94,794	\$ 318,476	\$ 94,794

The accompanying notes are an integral part of these condensed consolidated interim financial statements.

ESI ENTERTAINMENT SYSTEMS INC.

Notes to the Condensed Consolidated Interim Financial Statements

For Three and Six Months Ending August 31, 2011

(Unaudited – expressed in Canadian dollars)

1. Nature and continuance of operations

ESI Entertainment Systems Inc. and its subsidiaries (together “ESI” or the “Company”) were incorporated as e-Success Inc. on December 9, 1999 under the *Canada Business Company Act*. On February 27, 2006, the Company was continued as a British Columbia company and changed its name to ESI Entertainment Systems Inc. The Company is continued under the laws of British Columbia, Canada and its Common Shares are listed on the Canadian National Stock Exchange (“CNSX”) under the symbol (“ESY”).

ESI Corporate

The address of the Company’s corporate office and principal place of business is Burnaby, British Columbia.

ESI is a software development company with two main independently operated and controlled subsidiaries: ESI Integrity Inc. (“Integrity”) and Citadel Commerce Corp. (“Citadel”). The two active subsidiaries are located in separate physical locations and operated autonomously with completely separate management, personnel and infrastructure. The Company also has a number of other minor subsidiaries described in note 3.

Integrity

Integrity provides software solutions for real-time auditing, 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 the term of each contract. The change in revenue is dependent on the number of contracts executed in a given year, which may vary substantially from year to year.

The cost of licensing revenue primarily consists of the cost of customizing the software and the cost of installing and testing the software. The cost of support revenues primarily relates to personnel support costs.

Citadel

Citadel’s primary product is its Instant Bank Transfer service. It earns a fee on each payment processed to and from end-users and e-commerce merchants.

Citadel provides on-line payment processing services including electronic cheques and paper cheques but its main focus is its instant online banking services. 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. Its existing infrastructure and personnel have the capability to process substantially larger volumes.

ESI ENTERTAINMENT SYSTEMS INC.

Notes to the Condensed Consolidated Interim Financial Statements

For Three and Six Months Ending August 31, 2011

(Unaudited – expressed in Canadian dollars)

The Instant Bank Transfer service uses a software product that assists the consumer to complete the details of an online bank transfer which simplifies the process and eliminates data entry errors. The software also detects when the customer initiated the transfer and the merchant is notified that the funds have been sent. Citadel uses proprietary back-office software to electronically scan Citadel bank accounts for received deposits and to notify merchants of changes in transaction states. Knowing that the funds have been sent by the customer allows the merchant to have a high level of confidence that the funds will soon be received by Citadel. This allows the merchant to provide the customer with instant access to their funds.

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 and six month period ended August 31, 2011 the Company earned income from operations of \$889,159 and \$521,192 (2010: (\$278,727) and (\$692,906)), respectively, with an operating cash flow of (\$81,925) and (\$55,836) - (2010: (\$78,210) and \$7,390) respectively. In addition, as at August 31, 2011 there is a working capital deficit of \$4,938,989 (2010: \$5,270,675).

The Company has made efforts to reduce costs incurred in its operations. The continued revenues from the Company's active businesses form the basis of management's opinion that the Company will meet its liabilities and commitments as they become due. The Company is currently monitoring all expenditures and implementing cash management strategies to ensure that it has adequate cash reserves to fund identified expenditure requirements.

Given the Company's operating losses and working capital deficit, there exists considerable uncertainty about the Company's ability to continue as a going concern. 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.

2. Basis of presentation**a) Statement of compliance and conversion to International Financial Reporting Standards ("IFRS")****Statement of compliance**

The condensed interim consolidated financial statements for the period ended August 31, 2011 have been prepared in accordance with International Accounting Standard 34, Interim Financial Reporting ("IAS 34") as issued by the International Accounting Standards Board ("IASB") and using the accounting policies the Company expects to adopt in its condensed interim consolidated financial statements as at and for the year ending February 28, 2011.

ESI ENTERTAINMENT SYSTEMS INC.

Notes to the Condensed Consolidated Interim Financial Statements

For Three and Six Months Ending August 31, 2011

(Unaudited – expressed in Canadian dollars)

The May 31, 2011 condensed interim consolidated financial statements were the Company's first consolidated financial statements prepared under IFRS. The Company adopted IFRS in accordance with IFRS 1 First-time Adoption of International Financial Reporting Standards ("IFRS 1") with a transition date to IFRS of March 1, 2010. Consequently the comparative figures for 2010 and the Company's consolidated statement of financial position as at March 1, 2010 have been restated from accounting principles generally accepted in Canada ("Canadian GAAP") to comply with IFRS.

These condensed interim consolidated financial statements should be read in conjunction with the Company's 2011 annual consolidated financial statements prepared in accordance with Canadian GAAP and in consideration of the IFRS transition disclosures included in note 20. In addition, IFRS 1 allows certain exemptions from retrospective application of IFRS in the opening consolidated statement of financial position. Where these have been used they are explained in Note 20.

Basis of measurement

These condensed interim consolidated financial statements are stated in Canadian dollars and were prepared on a going concern basis, under the historical cost convention.

Use of estimates and judgments

The preparation of condensed interim consolidated financial statements in conformity with IFRS requires management to make judgments, estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Although these estimates are based on management's best knowledge of the amount, event or actions, actual results ultimately may differ from those estimates. Areas where estimates are significant to the interim consolidated financial statements are disclosed in note 4.

Functional and presentation currency

These condensed interim consolidated financial statements are presented in Canadian dollars, which is the Company's functional currency.

3. Summary of significant accounting policies

The principal accounting policies applied in the preparation of these condensed interim consolidated financial statements are set out below. These policies have been consistently applied to all the years presented, unless otherwise stated.

A) Basis of consolidation

Subsidiaries are an entity controlled by ESI. Control is achieved where the entity has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. The results of subsidiaries acquired or disposed of during the year are included in the consolidated statement of comprehensive income from the effective date of acquisition and up to the effective date of disposal, as appropriate.

ESI ENTERTAINMENT SYSTEMS INC.

Notes to the Condensed Consolidated Interim Financial Statements

For Three and Six Months Ending August 31, 2011

(Unaudited – expressed in Canadian dollars)

Where necessary, adjustments are made to the financial statements of subsidiaries to bring their accounting policies into line with those used by other members of the Group.

Intra-group balances and transactions, and any unrealized gains and losses or income and expenses arising from intra-group transactions are eliminated in preparing the condensed interim consolidated financial statements. Unrealized gains arising from transactions with associates are eliminated to the extent of the Company's interest in the entity. Unrealized losses are eliminated in the same way as unrealized gains, but only to the extent that there is no evidence of impairment.

These consolidated financial statements include the accounts of the Company and the following direct and indirect subsidiaries:

Active:

- ESI Integrity Inc. – wholly-owned subsidiary incorporated in Canada
- Citadel Commerce Corp – wholly-owned subsidiary incorporated in Canada
- Citadel Commerce UK Limited – wholly-owned subsidiary incorporated in United Kingdom
- ESI Holdings (Malta) Limited – wholly-owned subsidiary incorporated in Malta
- Citadel Commerce (Malta) Limited – wholly-owned subsidiary incorporated in Malta
- CC Mexico Holdings, S. de R.L. de C.V. – wholly-owned subsidiary incorporated in Mexico

Inactive:

- Playline Inc. – wholly-owned subsidiary incorporated in Canada
- Fortress Technologies Limited – wholly-owned subsidiary incorporated in Malta
- Playline Technologies Limited – wholly-owned subsidiary incorporated in Malta

B) Foreign currency translation

Items included in the condensed interim consolidated financial statements of each of the Company's subsidiaries are measured using the currency of the primary economic environment in which the entity operates (the "functional currency"). Foreign currency transactions are translated into the functional currency using the exchange rates prevailing at the dates of the transaction. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation of monetary assets and liabilities not denominated in the functional currency of an entity are recognized in the consolidated statement of comprehensive income.

Assets and liabilities of foreign operations with functional currencies other than Canadian dollars are translated at the period end rates of exchange, and the results of their operations are translated at average rates of exchange for the period. The resulting translation adjustments are included in other comprehensive income (loss) in shareholders' equity.

Foreign exchange gains and losses related to intercompany loans forming part of a reporting entity's net investment in a foreign operation are included in other comprehensive income (loss). All other foreign exchange gains and losses are recognized in the consolidated statement of comprehensive income.

ESI ENTERTAINMENT SYSTEMS INC.

Notes to the Condensed Consolidated Interim Financial Statements

For Three and Six Months Ending August 31, 2011

(Unaudited – expressed in Canadian dollars)

C) Cash and cash equivalents

Cash and cash equivalents consist of cash on hand and short-term deposits with initial maturities of equal to or less than 90 days.

D) Deferred product development costs

Deferred product development costs represent material costs incurred by the Company primarily related to the development of new auditing software, quality assurance processes and the user interface application to improve their existing products. Costs associated with projects in condition necessary for them to be capable of operating in the manner intended by management are depreciated over the estimated useful lives of the projects. Development costs incurred on new product development projects, which in management's view have clearly defined market prospects, are technologically feasible and for which the Company intends to commit resources, are deferred and will be amortized over its estimated useful life once revenue is earned after implementation. However, if at any time a product is deemed no longer commercially viable or facts and circumstances suggest that the carrying amount exceeds the recoverable amount, the balance of deferred development costs is expensed.

E) Deferred contract costs

Contract costs incurred for the installation of software pursuant to license agreements with Integrity are included in deferred contract costs. These expenditures generally relate to materials and direct labour costs and are charged to direct cost of revenues earned by Integrity over the term of the related revenue contract. When it is determined that expenditures will not likely be recovered by future revenue, such expenditures are included in current year's statement of loss and comprehensive loss. There is no impairment of deferred contract costs as at August 31, 2011.

F) Non-derivative financial instruments

Non-derivative financial instruments are recognized when the Company becomes a party to the contractual provisions of the instrument. Financial assets are derecognized when the rights to receive cash flows from the assets have expired or have been transferred and the Company has transferred substantially all risks and rewards of ownership. Non-derivative financial instruments are recognized initially at fair value plus, for instruments not at fair value through profit or loss, any directly attributable transaction costs.

At initial recognition, all financial instruments are classified in one of the following categories depending on the purpose for which the instruments were acquired:

Loans and receivables

Loans and receivables are subsequently measured at amortized cost using the effective interest method, less any impairment losses, with interest expense recognized on an effective yield basis. The asset classified in this category is accounts receivable.

ESI ENTERTAINMENT SYSTEMS INC.

Notes to the Condensed Consolidated Interim Financial Statements

For Three and Six Months Ending August 31, 2011

(Unaudited – expressed in Canadian dollars)

Financial assets at fair value through profit or loss

Financial assets at fair value through profit or loss (“FVTPL”) are financial assets held for trading or is designated as such by management. Such assets are held for trading if it is acquired principally for the purpose of selling in the short-term. These assets are initially recognized, and subsequently carried, at fair value, with changes recognized in the statement of comprehensive income. Transaction costs are expensed. Assets in this category include cash and cash equivalents, Citadel processing accounts and Citadel processing liabilities.

Other financial liabilities

Other financial liabilities are initially measured at fair value, net of transaction costs, and are subsequently measured at amortized cost using the effective interest method, with interest expense recognized on an effective yield basis. Liabilities in this category include accounts payable and accruals and loan payable.

Equity instruments

An equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities. Equity instruments issued by the Company are recorded at the proceeds received, net of direct issue costs.

G) Revenue recognition

Revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable, the costs incurred, or to be incurred in respect to the transaction can be measured reliably and collection is reasonably assured at the time of recognition.

For Integrity contracts with multiple deliverables, such as software licenses and support services, these arrangements do not qualify for separate units of accounting as there is no vendor specific objective and reliable evidence of their fair value. Accordingly, the software license and the software support services revenue are recognized over the remaining term of the related support services contract, subject to the delivery and installation of the software and acceptance by the customer. Deferred revenue consists of unearned license fees received prior to delivery, installation and acceptance by the customer, unamortized license and support fees revenue and advance payments of annual support service.

Citadel’s revenue from transaction processing services is recognized on execution of the underlying transactions. Revenue from consulting and support services is recognized as such services are provided.

Revenue is measured at the fair value of the consideration received or receivable.

H) Property and equipment (“PP&E”)

Property, plant and equipment are stated at cost less accumulated depreciation and accumulated impairment losses.

Cost comprises the fair value of consideration given to acquire or construct an asset and includes the direct charges associated with bringing the asset to the location and condition necessary for putting it into use, along with borrowing costs as applicable. When parts of an item of PP&E have different useful lives, they are accounted for as a separate item of PP&E.

ESI ENTERTAINMENT SYSTEMS INC.

Notes to the Condensed Consolidated Interim Financial Statements

For Three and Six Months Ending August 31, 2011

(Unaudited – expressed in Canadian dollars)

Gains and losses on disposal of an item of PP&E are determined by comparing the proceeds from disposal with the carrying amount of PP&E, and are recognized as gain or loss on disposal of assets.

Depreciation is charges to the statement of comprehensive income on the straight-line basis to recognize the cost less estimated residual value over the estimated useful lives of the assets, as follows:

- Computer hardware 3 years
- Computer software 3 years
- Equipment under capital leases 3 years
- Leasehold improvements 5 years
- Furniture and fixtures 10 years

I) Impairment**Financial assets**

A financial asset is assessed at each reporting date to determine whether there is any objective evidence that it is impaired. Significant financial difficulties of a debtor, probability that the debtor will enter bankruptcy or financial reorganization, and default or delinquency in payments are considered indicators that the trade receivable is impaired. The amount of the provision is the difference between the asset's carrying amount and the present value of estimated future cash flows, discounted at the original effective interest rate. The carrying amount of the asset is reduced through the use of an allowance account, and the amount of the loss is recognized in the statement of comprehensive income. When a trade receivable is uncollectible, it is written off against the allowance account for trade receivables.

Non-financial assets

At the end of each reporting period, the Company reviews the carrying amounts of its long lived assets to determine whether there is any indication that those assets have suffered an impairment loss. If any such indication exists, the recoverable amount of the asset is estimated in order to determine the extent of the impairment loss (if any). Where it is not possible to estimate the recoverable amount of an individual asset, the Company estimates the recoverable amount of the cash-generating unit ("CGU") to which the asset belongs. Where a reasonable and consistent basis of allocation can be identified, corporate assets are also allocated to individual CGU's, or otherwise they are allocated to the smallest group of CGU's for which a reasonable and consistent allocation basis can be identified.

Recoverable amount is the higher of fair value less costs to sell and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset for which the estimates of future cash flows have not been adjusted. If the recoverable amount of an asset or CGU is estimated to be less than its carrying amount, the carrying amount of the asset or CGU is reduced to its recoverable amount. An impairment loss is recognized immediately in comprehensive income.

ESI ENTERTAINMENT SYSTEMS INC.

Notes to the Condensed Consolidated Interim Financial Statements

For Three and Six Months Ending August 31, 2011

(Unaudited – expressed in Canadian dollars)

Where an impairment loss subsequently reverses for assets with a finite useful life, the carrying amount of the asset or CGU is increased to the revised estimate of its recoverable amount, but so that the increased carrying amount does not exceed the carrying amount that would have been determined had no impairment loss been recognized for the asset or CGU in prior years. A reversal of an impairment loss is recognized immediately in the statement of comprehensive income.

J) Share-based compensation

The Company operates a number of equity-settled compensation plans under which it receives services from employees, directors, officers, and consultants as consideration for equity instruments of the Company.

The Company uses the Black-Scholes pricing model to estimate the fair value of equity-settled awards at the grant date. The expense is recognized over the vesting period, which is the period over which all of the specified vesting conditions are satisfied. For awards with graded vesting, the fair value of each tranche is recognized over its respective vesting period.

No expense is recognized for awards that do not ultimately vest, except for equity-settled awards where vesting is conditional upon a market or non-vesting condition, which are treated as vesting irrespective of whether or not the market or non-vesting condition is satisfied, provided that all other performance and/or service conditions are satisfied.

K) Income taxes

Tax expense comprises current and deferred tax. Tax is recognized in the consolidated income statement except to the extent it relates to items recognized in other comprehensive income or directly in equity.

Current Income tax

Current tax expense is based on the results for the period as adjusted for items that are not taxable or not deductible. Current tax is calculated using tax rates and laws that were enacted or substantively enacted at the end of the reporting period. Management periodically evaluates positions taken in tax returns with respect to situations in which applicable tax regulation is subject to interpretation. Provisions are established where appropriate on the basis of amounts expected to be paid to the tax authorities.

Deferred tax

Deferred taxes are the taxes expected to be payable or recoverable on differences between the carrying amounts of assets in the consolidated statement of financial position and their corresponding tax bases used in the computation of taxable profit, and are accounted for using the balance sheet liability method. Deferred tax liabilities are generally recognized for all taxable temporary differences between the carrying amounts of assets and their corresponding tax bases. Deferred tax assets are recognized to the extent that it is probable that taxable profits will be available against which deductible temporary differences can be utilized. Such assets and liabilities are not recognized if the temporary difference arises from the initial recognition of goodwill or from the initial recognition (other than in a business combination) of other assets in a transaction that affects neither the taxable profit nor the accounting profit.

ESI ENTERTAINMENT SYSTEMS INC.

Notes to the Condensed Consolidated Interim Financial Statements

For Three and Six Months Ending August 31, 2011

(Unaudited – expressed in Canadian dollars)

Deferred tax liabilities:

- are generally recognized for all taxable temporary differences;
- are recognized for taxable temporary differences arising on investments in subsidiaries except where the reversal of the temporary difference can be controlled and it is probable that the difference will not reverse in the foreseeable future; and
- are not recognized on temporary differences that arise from goodwill which is not deductible for tax purposes.

Deferred tax assets:

- are recognized to the extent it is probable that taxable profits will be available against which the deductible temporary differences can be utilized; and
- are reviewed at the end of the reporting period and reduced to the extent that it is no longer probable that sufficient taxable profits will be available to allow all or part of the asset to be recovered.

Deferred tax assets and liabilities are not recognized in respect of temporary differences that arise on initial recognition of assets and liabilities acquired other than in a business combination.

L) Earnings (Loss) per share (“EPS”)

Basic EPS is calculated by dividing profit or loss attributable to owners of the Company (the numerator) by the weighted average number of ordinary shares outstanding (the denominator) during the period. The denominator (number of units) is calculated by adjusting the shares in issue at the beginning of the period by the number of shares bought back or issued during the period, multiplied by a time-weighting factor.

Diluted EPS is calculated by adjusting the earnings and number of shares for the effects of dilutive options and other dilutive potential units. The effects of anti-dilutive potential units are ignored in calculating diluted EPS. All options are considered anti-dilutive when the Company is in a loss position.

M) Leases

A lease that transfers substantially all of the benefits and risks of ownership is classified as a finance lease. At the inception of the lease, an asset and a payment obligation are recorded at an amount equal to the lesser of the present value of the minimum lease payments and the property’s fair market value. Assets under finance lease are amortized on the declining balance basis over their estimated useful lives of approximately five years. All other leases are accounted for as operating leases under which lease costs are expensed as incurred. Lease payments expensed for the three and six months ended August 31, 2011 amounted to \$56,140 and \$112,281 (August 31, 2010 - \$50,345 and \$100,691) respectively.

N) Finance Costs

Finance expenses comprise interest expense on borrowings and any impairment losses recognized on financial assets.

ESI ENTERTAINMENT SYSTEMS INC.

Notes to the Condensed Consolidated Interim Financial Statements

For Three and Six Months Ending August 31, 2011

(Unaudited – expressed in Canadian dollars)

Borrowing costs incurred for the development of qualifying assets are capitalized during the period of time that is required to complete and prepare the assets for their intended use or sale. All other borrowing costs are recognized in the consolidated statement of comprehensive income using the effective interest method. Interest has been capitalized at the rate of interest applicable to the specific borrowings financing the asset, or where financed through general borrowings, at a capitalization rate representing the average interest rate on such borrowings.

O) Segment Reporting

The executive committee reviews the Company's internal reporting in order to assess performance and allocate resources. Management has determined the operating segments based on these reports. The committee assesses the business from a functional perspective, distinguishing from the revenue streams attributable to Integrity, Citadel and ESI Entertainment Inc. ("Corporate").

P) Recent accounting pronouncements

The Company has reviewed new and revised accounting pronouncements that have been issued but are not yet effective and determined that the following may have an impact on the Company:

i) IFRS 9 – Financial Instruments

IFRS 9, 'Financial Instruments' was issued in November 2009 as the first step in its project to replace IAS 39 'Financial Instruments: Recognition and Measurement'. IFRS 9 introduces new requirements for classifying and measuring financial assets that must be applied starting January 1, 2013, with early adoption permitted. The IASB intends to expand IFRS 9 during the intervening period to add new requirements for classifying and measuring financial liabilities, de-recognition of financial instruments, impairment and hedge accounting. The Company is currently assessing the impact of this standard.

ii) IFRS 10 – Consolidated Financial Statements

IFRS 10, 'Consolidated Financial Statements' was issued in May 2011 and will supersede the consolidation requirements in SIC-12 'Consolidation – Special Purpose Entities' and IAS 27 'Consolidated and Separate Financial Statements' effective for annual periods beginning on or after January 1, 2013, with early application permitted. IFRS 10 builds on existing principles by identifying the concept of control as the determining factor in whether an entity should be included within the consolidated financial statements of the parent company. The standard also provides additional guidance to assist in the determination of control where this is difficult to assess. The Company is currently assessing the impact of this standard.

iii) IFRS 12 – Disclosure of Interests in Other Entities

IFRS 12, 'Disclosure of Interests in Other Entities' was issued in May 2011 and is a new and comprehensive standard on disclosure requirements for all forms of interests in other entities, including subsidiaries, joint arrangements, associates and unconsolidated structured entities. IFRS 12 is effective for annual periods beginning on or after January 1, 2013, with earlier application permitted. The Company is currently assessing the impact of this standard.

ESI ENTERTAINMENT SYSTEMS INC.

Notes to the Condensed Consolidated Interim Financial Statements

For Three and Six Months Ending August 31, 2011

(Unaudited – expressed in Canadian dollars)

iv) IFRS 13 – Fair Value Measurement

IFRS 13, 'Fair Value Measurement' was issued in May 2011 and sets out in a single IFRS a framework for measuring fair value. IFRS 13 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. This definition of fair value emphasizes that fair value is a market-based measurement, not an entity-specific measurement. In addition, IFRS 13 also requires specific disclosures about fair value measurement. IFRS 13 is effective for annual periods beginning on or after January 1, 2013, with earlier application permitted. The Company is currently assessing the impact of this standard.

4. Critical accounting estimates and judgments

The preparation of financial statements requires management to make judgments, estimates and assumptions that affect the application of policies and reported amounts of assets, liabilities and contingent liabilities as at the date of the consolidated financial statements, and the reported amount of revenues and expenses during the reporting period. Estimates and judgments are continuously evaluated and are based on management's experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances. Actual results may differ from these estimates.

The key sources of estimation uncertainty that have a significant risk of causing material adjustment to the amounts recognized in the condensed consolidated interim financial statements are as follows:

(i) Deferred product development costs

Deferred product development costs are represent costs incurred by the Company primarily related to the development of new auditing software, quality assurance processes and the user interface application to improve their existing products. Deferred development costs, net of related investment tax credits, are expensed as incurred unless they meet the following criteria for deferral and depreciation under IFRS:

1. the technical feasibility of completing the asset so that it will be available for use or sale;
2. the Company has the intention and ability to complete the asset and obtain economic benefit through its use or sale;
3. the extent and nature of the future economic benefits. Among other things the Company must demonstrate the existence of a market for the output of the asset and will deliver an appropriate financial return;
4. the availability and probability of obtaining appropriate technical and other resources to complete the product and to use or sell the asset;
5. the availability of product finance, or the existence of a market for the product if sold; and,
6. its ability to measure reliably the expenditure attributable to the asset during the development phase.

In accordance with IAS 36, the Company is required to test these assets for impairment by comparing their recoverable amount with their carrying amount, annually and whenever there is an indication that the asset may be impaired.

ESI ENTERTAINMENT SYSTEMS INC.

Notes to the Condensed Consolidated Interim Financial Statements

For Three and Six Months Ending August 31, 2011

(Unaudited – expressed in Canadian dollars)

Deferred product development costs are not depreciated until they have been completed and have been implemented for use within the Company.

There is a risk that if the market conditions or underlying product assumptions change, such that the forecast product returns are no longer deemed to be sufficient either in part or in total to justify the continued development of the project, then the carrying value of the asset may be written down, or written off in the future. There is no impairment of deferred development costs as at August 31, 2011 (2010 – nil), nor as at February 28, 2011.

(ii) Share-based payments

The Company measures the cost of equity-settled transactions with employees by reference to the fair value of the equity instruments at the date at which they are granted. Estimating fair value for share-based payment transactions requires determining the most appropriate valuation model, which is dependent on the terms and conditions of the grant. This estimate also requires determining and making assumptions about the most appropriate inputs to the valuation model including the expected life, volatility and dividend yield of the share option.

(iii) Useful lives of property and equipment

The Company estimates the useful lives of property, plant and equipment based on the period over which the assets are expected to be available for use. The estimated useful lives of property, plant and equipment are reviewed periodically and are updated if expectations differ from previous estimates due to physical wear and tear, technical or commercial obsolescence and legal or other limits on the use of the relevant assets. In addition, the estimation of the useful lives of property, plant and equipment are based on internal technical evaluation and experience with similar assets. It is possible, however, that future results of operations could be materially affected by changes in the estimates brought about by changes in factors mentioned above. The amounts and timing of recorded expenses for any period would be affected by changes in these factors and circumstances. A reduction in the estimated useful lives of the property, plant and equipment would increase the recorded expenses and decrease the non-current assets.

(iv) Impairment of non-financial assets

Impairment exists when the carrying value of an asset or cash generating unit exceeds its recoverable amount, which is the higher of its fair value less costs to sell and its value in use. The fair value less costs to sell calculation is based on available data from binding sales transactions in an arm's length transaction of similar assets or observable market prices less incremental costs for disposing of the asset. The value in use calculation is based on a discounted cash flow model. The cash flows are derived from the budget for the next five years and do not include restructuring activities that the Company is not yet committed to or significant future investments that will enhance the asset's performance of the cash generating unit being tested. The recoverable amount is most sensitive to the discount rate used for the discounted cash flow model as well as the expected future cash inflows and the growth rate used for extrapolation purposes.

ESI ENTERTAINMENT SYSTEMS INC.

Notes to the Condensed Consolidated Interim Financial Statements

For Three and Six Months Ending August 31, 2011

(Unaudited – expressed in Canadian dollars)

(v) Taxes

Provisions for taxes are made using the best estimate of the amount expected to be paid based on a qualitative assessment of all relevant factors. The Company reviews the adequacy of these provisions at the end of the reporting period. However, it is possible that at some future date an additional liability could result from audits by taxing authorities. Where the final outcome of these tax-related matters is different from the amounts that were initially recorded, such differences will affect the tax provisions in the period in which such determination is made.

5. 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:

	August 31, 2011	February 28, 2011	March 1, 2010
Merchant processing funds	\$ 6,040,889	\$ 5,272,083	\$ 5,581,442
Merchant reserves	-	47,220	58,101
myCitadel consumer funds	1,874	1,839	9,696
	<u>\$ 6,042,763</u>	<u>\$ 5,321,142</u>	<u>\$ 5,649,239</u>

Merchant processing funds are funds held with Citadel on behalf of the 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.

ESI ENTERTAINMENT SYSTEMS INC.

Notes to the Condensed Consolidated Interim Financial Statements

For Three and Six Months Ending August 31, 2011

(Unaudited – expressed in Canadian dollars)

6. Capitalized development costs

	<u>\$</u>
Cost	
At March 1, 2010	47,532
Additions	114,748
At February 28, 2011	<u>162,820</u>
Additions	167
At August 31, 2011	<u>162,987</u>
Depreciation and impairment	
At March 1, 2010	-
Charge for the year	2,565
At February 28, 2011	<u>2,565</u>
Charge for the period	16,297
At August 31, 2011	<u>18,862</u>
Net book value	
March 1, 2010	47,532
February 28, 2011	160,255
August 31, 2011	<u>144,125</u>

ESI ENTERTAINMENT SYSTEMS INC.

Notes to the Condensed Consolidated Interim Financial Statements

For Three and Six Months Ending August 31, 2011

(Unaudited – expressed in Canadian dollars)

7. Property and equipment

	Computer hardware \$	Computer software \$	Leasehold improvements \$	Furniture and fixtures \$	Total \$
Cost					
At March 1, 2010	1,202,500	507,643	134,037	246,702	2,090,882
Additions	3,219	-	-	-	3,219
At February 28, 2011	1,205,719	507,643	134,037	246,702	2,094,101
Additions	6,925	2,681	-	-	9,606
At August 31, 2011	1,212,644	510,324	134,037	246,702	2,103,707
Depreciation and impairment					
At March 1, 2010	1,167,898	487,377	98,661	166,447	1,920,383
Charge for the year	15,346	9,520	7,470	18,380	50,716
At February 28, 2011	1,183,244	496,897	106,131	184,827	1,971,099
Charge for the period	9,250	5,738	3,766	6,527	25,281
At August 31, 2011	1,192,494	502,635	109,837	191,354	1,996,380
Net book value					
March 1, 2010	34,602	20,266	35,376	80,255	170,499
February 28, 2011	22,475	10,746	27,906	61,875	123,002
August 31, 2011	20,150	7,689	24,141	55,348	107,327

8. Deferred contract costs

	<u>\$</u>
March 1, 2010	550,362
Additions	-
Recognized through income	<u>(167,680)</u>
February 28, 2011	382,682
Additions	-
Recognized through income	<u>(14,536)</u>
August 31, 2011	<u><u>368,146</u></u>

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. During the three month period ending August 31, 2011, US \$ 16,775 of interest payments were made towards the outstanding balance and US \$ 32,592 interest expense was incurred.

10. Share capital and share purchase option compensation plan

a) Authorized capital

At August 31, 2011, the authorized share capital comprised an unlimited number of common shares. The common shares do not have a par value. All issued shares are fully paid. Issued share capital as at August 31, 2011 amounted to \$9,957,969. There were no movements in the issued share capital of the Company in either the current or the prior interim reporting periods, nor the year of transition.

b) Share purchase option compensation plan

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. 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. Options have a maximum term of ten years and typically terminate 60 days following the termination of the optionee's employment or engagement, except in the case of retirement or death. Vesting of options is at the discretion of the Board of Directors at the time the options are granted.

ESI ENTERTAINMENT SYSTEMS INC.

Notes to the Condensed Consolidated Interim Financial Statements

For Three and Six Months Ending August 31, 2011

(Unaudited – expressed in Canadian dollars)

A summary of the outstanding and exercisable share purchase options for the period ended August 31, 2011 and the year ended February 28, 2011 is as follows:

	Number	Weighted Average Exercise Price
Outstanding at March 1, 2010	1,960,000	\$ 0.60
Expired	(33,250)	\$ 0.27
Cancelled	(815,000)	\$ 0.87
Granted	481,000	\$ 0.05
Forfeited	(33,750)	\$ 0.65
Outstanding at February 28, 2011	1,559,000	\$0.05
Forfeited during the period	(167,000)	\$0.05
Outstanding at August 31, 2011	1,392,000	\$0.05
Exercisable at August 31, 2011	1,080,250	\$ 0.05

During the period ending August 31, 2011, no options were granted (2010 – nil).

During the six months ending August 31, 2011, no options were cancelled or expired, 167,000 were forfeited (2010 – 30,750). 311,750 options became exercisable during the 3 month period ended August 31, 2011. During the year ended February 28, 2011, the Company repriced stock option awards to officers and employees. Such options were repriced at a new exercise price of \$0.05 per share. The Company has accounted for the repricing as a modification under IFRS 2. The modification did not result in additional compensation, however it accelerated the vesting to one year.

At August 31, 2011, the Company has share purchase options outstanding entitling the holders thereof the right to purchase one common share for each option held as follows:

Number	Exercise Price	Expiry Date	Weighted average remaining contractual life (years)
145,000	\$ 0.05	October 14, 2019	8.12
1,247,000	\$ 0.05	September 1, 2020	9.00
1,392,000			8.92

ESI ENTERTAINMENT SYSTEMS INC.

Notes to the Condensed Consolidated Interim Financial Statements

For Three and Six Months Ending August 31, 2011

(Unaudited – expressed in Canadian dollars)

The weighted average fair value of share purchase options granted during the year ended February 28, 2011 was \$0.05 per option and was estimated on the grant date using the Black-Scholes option pricing model. The assumptions used in calculating fair value of options granted in fiscal 2011 are as follows:

	<u>2011</u>
Expected dividend yield	Nil
Expected volatility	332%
Risk-free interest rate	1.26
Expected term in years	1 year
Forfeiture rate	10%

C) Contributed surplus

The contributed surplus reserve is used to recognise the fair value of share options granted to employees, including key management personnel, as part of their remuneration. When options are subsequently exercised, the fair value of such options in contributed surplus is credited to share capital.

As at March 1, 2010	4,500,536
Share-based payment	98,760
As at February 28, 2011	<u>4,599,296</u>
Share-based payment	(9,414)
As at August 31, 2011	<u>4,589,882</u>

11. Loss per share

	Income (loss) for the period	Weighted average number of shares	Per share amount
Period ended August 31, 2011			
Income (loss) attributable to ordinary shareholders	\$ 521,192	14,234,727	\$0.04
Period ended August 31, 2010			
Income (loss) attributable to ordinary shareholders	\$ (692,906)	14,234,727	\$(0.05)

For the periods ended August 31, 2011 and 2010, potentially dilutive common shares (relating to share purchase options) were not included in the computation of loss per share as the effect would be anti-dilutive.

ESI ENTERTAINMENT SYSTEMS INC.

Notes to the Condensed Consolidated Interim Financial Statements

For Three and Six Months Ending August 31, 2011

(Unaudited – expressed in Canadian dollars)

12. Revenue and Expenses by nature**a) Revenue**

	Three months ending August 31		Six months ending August 31	
	2011	2010	2011	2010
Integrity	\$ 345,725	\$ 440,076	\$ 762,377	\$ 873,929
Citadel	550,153	381,953	1,076,362	691,365
Total Revenue	\$ 895,878	\$ 822,029	\$ 1,838,739	\$ 1,565,294

b) General and administration expenses

	Three months ending August 31		Six months ending August 31	
	2011	2010	2011	2010
Product Development	\$ 56,481	\$ -	\$ 59,837	\$ -
Sales, Marketing and customer service	27,440	29,035	59,664	60,419
Depreciation	20,086	12,370	41,578	26,345
Salaries (Note 17, 19)	(217,338)	456,256	(80,375)	938,105
Professional fees	88,647	72,465	158,981	117,812
Other expenses	91,295	153,979	178,594	285,201
Total	\$ 66,611	\$ 724,105	\$ 418,277	\$ 1,427,882

13. Income Taxes

The Company has not recorded a provision for income taxes for the six month period ended August 31, 2011 (2010 – nil) nor for the year ended February 28, 2011 due to the accumulated non-capital losses accumulated by the Company and its subsidiaries. The Company has not recorded a deferred tax asset for the six month period ended August 31, 2011 (2010 – nil) nor for the year ended February 28, 2011 due to uncertainty of the Company's ability to attain future profitability sufficient to recognize such assets.

14. 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.

The Company has not entered into any operating lease commitments during the three or six month period ended August 31, 2011.

ESI ENTERTAINMENT SYSTEMS INC.

Notes to the Condensed Consolidated Interim Financial Statements
For Three and Six Months Ending August 31, 2011
(Unaudited – expressed in Canadian dollars)

15. Capital management

Management defines capital as the Company's total shareholders' equity. The Board of Directors does not establish a quantitative return on capital for management, but rather promotes year over year sustainable profitable growth. The consolidated capital structure for the Company at August 31, 2011, February 28, 2011 and March 1 2010 is as follows:

	<u>August 31, 2011</u>	<u>February 28, 2011</u>	<u>March 1, 2010</u>
Share Capital	\$ 9,957,969	\$ 9,957,969	\$ 9,957,969
Contributed Surplus	4,589,882	4,599,296	4,500,536
Other comprehensive income (loss)	(69,024)	23,318	-
Deficit	19,244,960	19,835,176	19,072,007

The Company's objectives when managing capital are to safeguard the entity's ability to continue as a going concern, so that it can continue to provide returns for shareholders and benefits for other stakeholders, as well as to generate sufficient cash flow to manage its existing debt.

The Company sets the amount of capital in proportion to risk and manages the capital structure and makes adjustments to it in light of changes to economic conditions and the risk characteristics of the underlying assets. In order to maintain or adjust the capital structure, the Company may issue new debt, issue new shares, or defer various expenses in order to conserve cash flow. Financing decisions are generally made on a specific transaction basis and depend on such things as the Company's needs, capital markets and economic conditions at the time of the transaction.

Management reviews its capital management approach on an ongoing basis and believes that this approach is reasonable, given the size of the Company.

16. Financial instruments and risk management

Set out below is a comparison by category of carrying amounts and fair values of all of the Company financial instruments that are carried in the financial statements and how the fair value of financial instruments measured.

Fair values

Fair value represents the price at which a financial instrument could be exchanged in an orderly market, in an arm's length transaction between knowledgeable and willing parties who are under no compulsion to act. The Company classifies the fair value of the financial instruments according to the following hierarchy based on the amount of observable inputs used to value the instrument.

The following table provides an analysis of the financial instruments that are measured subsequent to initial recognition at fair value, grouped into Levels 1 to 3 based on the degree to which the fair value is observable.

- Level 1 fair value measurements are those derived from quoted prices (unadjusted) in the active market for identical assets or liabilities.
- Level 2 fair value measurements are those derived from inputs other than quoted prices that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (derived from prices)
- Level 3 fair value measurements are those derived from valuation techniques that include inputs for the asset or liability that are not based on observable market data (unobservable inputs).

ESI ENTERTAINMENT SYSTEMS INC.

Notes to the Condensed Consolidated Interim Financial Statements

For Three and Six Months Ending August 31, 2011

(Unaudited – expressed in Canadian dollars)

Financial Instrument Classification	Note	August 31, 2011		February 28, 2011	
		Carrying Value	Fair value	Carrying Value	Fair value
		\$	\$	\$	\$
FVTPL:					
Cash and cash equivalents	(a)	318,476	318,476	17,742	17,742
Citadel processing accounts	(a)	4,672,451	4,672,451	4,277,252	4,277,252
Citadel Processing liabilities	(a)	6,042,762	6,042,762	5,321,142	5,321,142
Loans and receivables:					
Accounts receivable	(b)	181,705	181,705	210,160	210,160
Other financial liabilities:					
Accounts payable and accruals	(b)	1,594,983	1,594,983	2,085,028	2,085,028
Loan Payable	(b)	2,126,902	2,126,902	2,081,567	2,081,567

(a) Fair values are determined from transaction values which reflect quoted active market prices. Fair values of these financial instruments are based on Level 1 measurements.

(b) Carrying value is measured at amortized cost using the effective interest rate method. The carrying values approximate fair values due to the short term nature of the instrument.

The Company's activities expose it to a variety of financial risks: credit risk, liquidity risk and market risk (currency fluctuations) The Company's overall risk management program focuses on the unpredictability of financial markets and seeks to minimise potential adverse effects on the Company's financial performance.

ESI ENTERTAINMENT SYSTEMS INC.

Notes to the Condensed Consolidated Interim Financial Statements

For Three and Six Months Ending August 31, 2011

(Unaudited – expressed in Canadian dollars)

Credit Risk

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

The ageing of receivables at August 31, 2011 was as follows (the ageing days relates to balances past due):

	Total	Current and <30 days	30-60 days
Net Trade Receivables	181,705	151,315	30,390

As at August 31, 2011, one customer accounted for 38% of the trade accounts receivable. The Company believes that there is no unusual exposure associated with the collection of these receivables. The Company performs regular credit assessments of its customers and provided allowances for potentially uncollectible accounts receivable.

Liquidity risk

The Company is exposed to liquidity risk, which is the risk that the Company may be unable to generate or obtain sufficient cash to meet its commitments as they become due. The financial liabilities on the balance sheet consist of accounts payable and accrued liabilities and loan payable. This risk is mitigated through the management of cash and loans received and the Company may adjust capital spending, issue new shares or draw additional debt.

Forecasted cash flows and operating and capital outlays are updated frequently to ensure necessary liquidity remains available. All of the Company's financial obligations are either demand or are due within one year.

Market risk

Market risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk is comprised of foreign currency risk. The objective of market risk management is to manage and control market price exposures within acceptable limits, while maximizing returns.

Foreign exchange risk

The reporting currency of the Company is Canadian dollars. The Company enters into transactions 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.

ESI ENTERTAINMENT SYSTEMS INC.

Notes to the Condensed Consolidated Interim Financial Statements

For Three and Six Months Ending August 31, 2011

(Unaudited – expressed in Canadian dollars)

17. Segmented information

The Company has adopted IFRS 8 *Operating Segments* with effect from March 1, 2010. IFRS 8 requires operating segments to be identified on the basis of internal reports about components of the Company that are regularly reviewed by the chief operating decision maker in order to allocate resources to the segment and assess its performance.

The Company comprises the following main operating segments:

- Integrity: The 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: 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.
- Corporate: The Company administration is performed at the head office in Burnaby, British Columbia, Canada and its activities include the Company's indirect support costs for the operating segments.

All of the Company's segment revenue is attributable to external customers, there are no inter-segment revenues.

During the period ending August 31, 2011, the Company received approval from certain Executives, Directors and Officers to forgive the majority of amounts owed to them by the Company for their deferred salaries along with the interest accrued on the unpaid amounts for a total of \$1.1 million. The reversal of the Salary Expense significantly reduced the Direct Costs and General and Administration Expense for the quarter ending August 31, 2011.

The segmented information for each operating segment is as follows:

ESI ENTERTAINMENT SYSTEMS INC.

Notes to the Condensed Consolidated Interim Financial Statements

For Three and Six Months Ending August 31, 2011

(Unaudited – expressed in Canadian dollars)

CITADEL Gross Profit	For the Three Months Ending August 31		For the Six Months Ending August 31	
	2011	2010	2011	2010
	Revenues	\$ 550,153	381,953	\$ 1,076,362
Direct Costs	(164,718)	255,629	491,324	524,643
Gross Profit	\$ 714,871	126,324	\$ 585,038	\$ 166,722

INTEGRITY Gross Profit	For the Three Months Ending August 31		For the Six Months Ending August 31	
	2011	2010	2011	2010
	Revenues	\$ 345,725	440,076	\$ 762,377
Direct Costs	146,427	226,970	299,574	455,369
Gross Profit	\$ 199,298	213,106	\$ 462,803	\$ 418,560

CONSOLIDATED Gross Profit	For the Three Months Ending August 31		For the Six Months Ending August 31	
	2011	2010	2011	2010
	Revenues	\$ 895,878	822,029	\$ 1,838,739
Direct Costs	(18,291)	482,599	790,898	980,012
Gross Profit	\$ 914,169	339,430	\$ 1,047,841	\$ 585,282

Reportable items in the statement of financial position

	<u>August 31, 2011</u>	<u>February 28, 2011</u>	<u>March 1, 2010</u>
Reportable Segment Assets			
Citadel	\$ 5,060,889	\$ 4,328,654	\$ 5,008,180
Integrity	745,515	818,003	1,115,487
Corporate	56,245	91,348	98,738
	\$ <u>5,862,649</u>	\$ <u>5,238,005</u>	\$ <u>6,222,405</u>

	<u>August 31, 2011</u>	<u>February 28, 2011</u>	<u>March 1, 2010</u>
Reportable Segment Liabilities			
Citadel	\$ 6,682,402	\$ 4,543,002	\$ 5,717,152
Integrity	970,172	1,192,917	1,633,484
Corporate	\$ 2,976,208	\$ 4,756,679	\$ 3,485,271
	\$ <u>10,628,782</u>	\$ <u>10,492,598</u>	\$ <u>10,835,907</u>

ESI ENTERTAINMENT SYSTEMS INC.

Notes to the Condensed Consolidated Interim Financial Statements

For Three and Six Months Ending August 31, 2011

(Unaudited – expressed in Canadian dollars)

Geographic location

Revenues are earned from merchants located in more than a dozen countries in the world, whose ultimate customers are located in numerous different countries, not necessarily the country in which a particular merchant is located. It is neither economic nor meaningful to identify in these financial statements the geographic location of each customer, since this is a constantly variable factor. The geographic location of principal merchant customers is readily identifiable as follows:

	For the Three Months Ending August 31		For the Six Months Ending August 31	
	2011	2010	2011	2010
United States	\$ 102,008	\$ 166,074	\$ 243,660	\$ 248,437
Canada	70,439	89,780	145,439	167,674
International other	723,431	566,175	1,449,640	1,149,183
	\$ 895,878	\$ 822,029	\$ 1,838,739	\$ 1,565,294

As at August, 31 2011, 79% of the Company's fixed assets were situated in Canada and 21% were located internationally.

18. Economic dependence

The Citadel business unit revenue consists of transaction processing. Customer dependency for Citadel revenue is as follows:

	For the Three Months Ending August 31		For the Six Months Ending August 31	
	2011	2010	2011	2010
Customer A	19%	25%	20%	22%
Customer B	12%	17%	14%	14%
Customer C	11%	12%	13%	9%
Customer D	9%	8%	9%	6%

The Integrity business unit revenue consists of 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. Customer dependency for Integrity revenue is as follows:

	For the Three Month Ending August 31		For the Six Months Ending August 31	
	2011	2010	2011	2010
Customer A	41%	39%	36%	40%
Customer B	20%	13%	18%	15%
Customer C	12%	11%	14%	12%
Customer D	9%	10%	7%	11%

ESI ENTERTAINMENT SYSTEMS INC.

Notes to the Condensed Consolidated Interim Financial Statements

For Three and Six Months Ending August 31, 2011

(Unaudited – expressed in Canadian dollars)

19. Related Party Transactions

During the three and six month period ending August 31, 2011, the Company received approval from certain Executives, Directors and Officers to forgive the majority of amounts owed to them by the Company for their deferred salaries along with the interest accrued on the unpaid amounts for a total of \$1.1 million.

20. Transition to IFRS

As disclosed in Note 2, these condensed interim consolidated financial statements represent ESI's presentation of the financial results of operations and financial position under IFRS for the period ended August 31, 2011 in conjunction with the Company's annual audited consolidated financial statements to be issued under IFRS as at and for the year-ended February 28, 2012. As a result, these condensed interim consolidated financial have been prepared in accordance with IFRS 1, "at the opening of First time Adoption of International Financial Reporting Standards" and with IAS 34, "Interim Financial Reporting", as issued by the IASB. Previously, the Company prepared its interim and annual consolidated financial statements in accordance with Canadian GAAP.

IFRS 1 requires the presentation of comparative information as at the March 1, 2010 transition date and subsequent comparative periods as well as the consistent and retrospective application of IFRS accounting policies. To assist with the transition, IFRS 1 allows for certain mandatory and optional exemptions for first time adopters to IFRS to alleviate the retrospective application of all IFRS.

The following reconciliations present the adjustments made to the Company's Canadian GAAP financial results of operations and financial position to comply with IFRS 1. A summary of the significant accounting policy changes and applicable exemptions are discussed following the reconciliations. Reconciliations include the Company's consolidated statement of financial positions as at March 1, 2010, August 31, 2010 and February 28, 2011, and consolidated statements of Comprehensive Income, Changes in Shareholders' Equity and Cash Flows for the three and six months ended August 31, 2010 and for the twelve months ended February 28, 2011.

ESI ENTERTAINMENT SYSTEMS INC.

Notes to the Condensed Consolidated Interim Financial Statements

For Three and Six Months Ending August 31, 2011

(Unaudited – expressed in Canadian dollars)

Reconciliation of consolidated statement of financial position and equity as at March 1, 2010

	Notes	Canadian GAAP	Effect of Transition to IFRS	IFRS
Assets				
Cash and cash equivalents		\$ 89,208	\$ -	\$ 89,208
Accounts receivable		361,745	-	361,745
Prepays		65,658	-	65,658
Citadel processing accounts		4,937,401	-	4,937,401
Current Assets		5,454,012	-	5,454,012
Capitalized development costs		47,532	-	47,532
Property and equipment		170,499	-	170,499
Deferred contact costs		550,362	-	550,362
		768,393	-	768,393
Total assets		\$ 6,222,405	\$ -	\$ 6,222,405
Liabilities				
Accounts payable and accrued liabilities		\$ 1,516,100	\$ -	\$ 1,516,100
Loan payable		2,174,733	-	2,174,733
Citadel processing liabilities		5,649,239	-	5,649,239
Deferred revenue		582,230	-	582,230
Current Liabilities		9,922,302	-	9,922,302
Deferred revenue		913,605	-	913,605
Total liabilities		10,835,907	-	10,835,907
Shareholders' Deficit				
Capital Stock		9,957,969	-	9,957,969
Contributed surplus	20B	4,467,539	32,997	4,500,536
Deficit		(19,039,010)	(32,997)	(19,072,007)
Total equity		(4,613,502)	-	(4,613,502)
Total liabilities and equity		\$ 6,222,405	\$ -	\$ 6,222,405

ESI ENTERTAINMENT SYSTEMS INC.

Notes to the Condensed Consolidated Interim Financial Statements

For Three and Six Months Ending August 31, 2011

(Unaudited – expressed in Canadian dollars)

Reconciliation of consolidated statement of financial position and equity as at August 31, 2010

	Notes	Canadian GAAP	Effect of Transition to IFRS	IFRS
Assets				
Cash and cash equivalents		\$ 94,794	\$ -	\$ 94,794
Accounts receivable		1,274,650	-	1,274,650
Prepays		103,990	-	103,990
Citadel processing accounts		4,648,617	-	4,648,617
Current Assets		6,122,051	-	6,122,051
Capitalized development costs		119,333	-	119,333
Property and equipment		147,372	-	147,372
Deferred contract costs		466,915	-	466,915
		733,620	-	733,620
Total assets		\$ 6,855,671	\$ -	\$ 6,855,671
Liabilities				
Accounts payable and accrued liabilities		\$ 2,928,682	\$ -	\$ 2,928,682
Loan payable		2,247,948	-	2,247,948
Citadel processing liabilities		5,720,798	-	5,720,798
Deferred revenue		495,288	-	495,288
Current Liabilities		11,392,716		11,392,716
Deferred revenue		774,681	-	774,681
Total liabilities		12,167,397	-	12,167,397
Equity				
Capital stock		9,957,969	-	9,957,969
Contributed surplus	20B	4,467,539	33,447	4,500,986
Other comprehensive income	20A	-	64,276	64,276
Deficit		(19,737,234)	(97,723)	(19,834,957)
Total equity		(5,311,726)	-	(5,311,726)
Total liabilities and equity		\$ 6,855,671	\$ -	\$ 6,855,671

ESI ENTERTAINMENT SYSTEMS INC.

Notes to the Condensed Consolidated Interim Financial Statements

For Three and Six Months Ending August 31, 2011

(Unaudited – expressed in Canadian dollars)

Reconciliation of consolidated statement of loss and comprehensive loss for the six months ended August 31, 2010

	Notes	Canadian GAAP	Effect of transition to IFRS	IFRS
Continuing operations				
Revenues		\$ 1,565,294	\$ -	\$ 1,565,294
Direct Costs		980,012	-	980,012
Gross Profit		585,282	-	585,282
General and administration expenses	20B	1,433,200	(5,318)	1,427,882
Loss before under noted items		(847,918)	5,318	(842,600)
Other expenses (income)				
Foreign exchange (gain) loss	20A	(250,935)	64,276	(186,659)
Interest income		(689)	-	(689)
Interest expense		101,930	-	101,930
Loss for the period		(698,224)	(58,958)	(757,182)
Other comprehensive income (loss)				
Foreign currency translation gain	20A	-	64,276	64,276
Net loss and comprehensive loss for the year		\$ (698,224)	\$ 5,318	\$ (692,906)

ESI ENTERTAINMENT SYSTEMS INC.

Notes to the Condensed Consolidated Interim Financial Statements

For Three and Six Months Ending August 31, 2011

(Unaudited – expressed in Canadian dollars)

Reconciliation of consolidated statement of loss and comprehensive loss for the three months ended August 31, 2010

	Notes	Canadian GAAP	Effect of transition to IFRS	IFRS
Continuing operations				
Revenues		\$ 822,029	\$ -	\$ 822,029
Direct Costs		482,599	-	482,599
Gross Profit		339,430	-	339,430
General and administration expenses	20B	728,802	(4,697)	724,105
Loss before under noted items		(389,372)	(4,697)	(384,675)
Other expenses (income)				
Foreign exchange (gain) loss	20A	(158,526)	64,276	(94,250)
Interest income		(645)	-	(645)
Interest expense		53,223	-	53,223
Loss for the period		(283,424)	(59,579)	(343,003)
Other comprehensive income (loss)				
Foreign currency translation gain	20A	-	64,276	64,276
Net loss and comprehensive loss for the year		\$ (283,424)	\$ 4,697	\$ (278,727)

ESI ENTERTAINMENT SYSTEMS INC.

Notes to the Condensed Consolidated Interim Financial Statements

For Three and Six Months Ending August 31, 2011

(Unaudited – expressed in Canadian dollars)

Reconciliation of consolidated statement of financial position and equity as at February 28, 2011

	Notes	Canadian GAAP	Effect of transition to IFRS	IFRS
Assets				
Cash and cash equivalents		\$ 17,742	\$ -	\$ 17,742
Accounts receivable		210,160	-	210,160
Prepays		66,912	-	66,912
Citadel processing accounts		4,277,252	-	4,277,252
Current Assets		4,572,066	-	4,572,066
Capitalized development costs		160,255	-	160,255
Property and equipment		123,002	-	123,002
Deferred contract costs		382,682	-	382,682
		665,939	-	665,939
Total assets		\$ 5,238,005	\$ -	\$ 5,238,005
Liabilities				
Accounts payable and accrued liabilities		\$ 2,085,028	\$ -	\$ 2,085,028
Loan payable		2,081,567	-	2,081,567
Citadel processing liabilities		5,321,142	-	5,321,142
Deferred revenue		485,367	-	485,367
Current Liabilities		9,973,104	-	9,973,104
Deferred revenue		519,494	-	519,494
Total liabilities		10,492,598	-	10,492,598
Equity				
Capital Stock		9,957,969	-	9,957,969
Contributed Surplus	20B	4,560,531	38,765	4,599,296
Other comprehensive income	20A	-	23,318	23,318
Deficit		(19,773,093)	(62,083)	(19,835,176)
Total equity		(5,254,593)	-	(5,254,593)
Total liabilities and equity		\$ 5,238,005	\$ -	\$ 5,238,005

ESI ENTERTAINMENT SYSTEMS INC.

Notes to the Condensed Consolidated Interim Financial Statements

For Three and Six Months Ending August 31, 2011

(Unaudited – expressed in Canadian dollars)

Reconciliation of consolidated statement of loss and comprehensive loss for the year ended February 28, 2011

	Notes	Canadian GAAP	Effect of transition to IFRS	IFRS
Continuing Operations				
Revenues		\$ 3,408,325	\$ -	\$ 3,408,325
Direct Costs		1,610,447	-	1,610,447
Gross Profit		1,797,878	-	1,797,878
General and administration expenses	20B	2,938,120	(23,524)	2,914,596
Loss before under noted items		(1,140,242)	23,524	(1,116,718)
Other expenses (income)				
Foreign exchange (gain) loss	20A	(581,718)	23,318	(558,400)
Interest income		(3,044)	-	(3,044)
Interest expense		241,288	-	241,288
Other		(62,685)	-	(62,685)
Loss for the period		(734,083)	206	(733,877)
Other comprehensive income (loss)				
Foreign currency translation gain	20A	-	23,318	23,318
Net loss and comprehensive loss for the year		\$ (734,083)	\$ 23,524	\$ (710,559)

ESI ENTERTAINMENT SYSTEMS INC.

Notes to the Condensed Consolidated Interim Financial Statements
For Three and Six Months Ending August 31, 2011
(Unaudited – expressed in Canadian dollars)

Restatement of the consolidated statement of cash flows for the period ended August 31, 2010

The restatement from Canadian GAAP to IFRS had no significant effect on the reported cash flows generated by the Company. The reconciling items between Canadian GAAP presentation and IFRS have no effect on the cash flows generated.

Restatement of the consolidated statement of cash flows for the year ended February 28, 2011

The restatement from Canadian GAAP to IFRS had no significant effect on the reported cash flows generated by the Company. The reconciling items between Canadian GAAP presentation and IFRS have no effect on the cash flows generated.

IFRS Adjustments

The following discussions explain the significant differences between ESI's previous GAAP accounting policies and those applied by the Company under IFRS. IFRS policies have been retrospectively and consistently applied, except where specific IFRS 1 optional and mandatory exemptions permitted an alternative treatment upon transition to IFRS for first-time adopters. The descriptive note captions below correspond to the adjustments presented in the preceding reconciliations.

A) Foreign Currency

Under Canadian GAAP, the Company's foreign subsidiaries were considered integrated with the Company and translated using the temporal method, with foreign exchange gains and losses being recognized through earnings. Under IFRS, translation gains and losses are recognized through other comprehensive income as the Company's foreign subsidiaries have a functional currency that differs from presentation currency of Canadian dollars. The impact arising from the change is summarized as follows:

Consolidated Statements of Financial Position	February 28, 2011	August 31, 2010	March 1, 2010
Increase in accumulated other comprehensive income	23,318	64,276	-
Increase to deficit	23,318	64,276	-
Consolidated Statements of Comprehensive Income			
Decrease in foreign exchange gain	23,318	64,276	-
Foreign currency translation gain	23,318	64,276	-

ESI ENTERTAINMENT SYSTEMS INC.

Notes to the Condensed Consolidated Interim Financial Statements

For Three and Six Months Ending August 31, 2011

(Unaudited – expressed in Canadian dollars)

On the transition to IFRS, non-monetary assets previously recorded as historical Canadian exchange rates were revalued as at March 1, 2010 using the spot rate in effect as at that date. In accordance with IFRS 1, the Company has elected to deem all foreign currency translation differences that arose prior to the date of transition in respect of all foreign operations to be nil at the date of transition. The requirement to translate non-monetary assets as at the transition date did not result in any restatement of the Company's financial statements as previously reported.

B) Shared based payments

Under Previous GAAP, the Company recognized an expense related to share-based compensation on a straight-line basis through the date of full vesting of the Company's stock options and did not incorporate a forfeiture rate in the fair value calculation at grant date. Under IFRS, the Company is required to recognize the expense over the individual vesting periods for the graded vesting awards and estimate a forfeiture rate at the grant date and update it throughout the vesting period. As a result of recognizing the expense using the graded vesting model and updating the expense based on estimated forfeitures, share-based compensation expense increased by \$38,765 as at the transition date of March 1, 2010, decreased \$5,318 for the six months ended August 31, 2010 and decreased \$23,524 for the year ended February 28, 2011.

Consolidated Statements of Financial Position	February 28, 2011	August 31, 2010	March 1, 2010
Increase (decrease) in contributed surplus	(23,524)	(5,318)	38,765
Increase (decrease) to deficit	(23,524)	(5,318)	38,765
Consolidated Statements of Comprehensive Income			
Increase (decrease) in General and Administrative expense	(23,524)	(5,318)	-