

# **ESI Entertainment Systems Inc.**

## **Consolidated Financial Statements**

**(expressed in Canadian dollars)**

**For the Years Ended February 28, 2009 and February  
29, 2008**

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## Management's Responsibility

To the Shareholders of ESI Entertainment Systems Inc.

Management is responsible for the preparation and presentation of the accompanying financial statements, including responsibility for significant accounting judgments and estimates in accordance with Canadian generally accepted accounting principles and ensuring that all information in the annual report is consistent with the statements. This responsibility includes selecting appropriate accounting principles and methods, and making decisions affecting the measurement of transactions in which objective judgment is used.

In discharging its responsibilities for the integrity and fairness of the consolidated financial statements, management designs and maintains the necessary accounting systems and related internal controls to provide reasonable assurance that transactions are authorized, assets are safeguarded and financial records are properly maintained to provide reliable information for the preparation of financial statements.

The Board of Directors and the Audit Committee are composed primarily of Directors who are neither management nor employees of the Company. The Board is responsible for overseeing management in the performance of its financial reporting responsibilities, and for approving the financial information included in the annual report. The Audit Committee has the responsibility of meeting with management and external auditors to discuss the internal controls over the financial reporting process, auditing matters and financial reporting issues. The Committee is also responsible for recommending the appointment of the Company's external auditors.

Meyers Norris Penny LLP, an independent firm of Chartered Accountants, is appointed by the shareholders to audit the consolidated financial statements and report directly to them; their report follows. The external auditors have full and free access to, and meet periodically and separately with, both the Audit Committee and management to discuss their audit findings.

May 28, 2009

"Tony Greening"

Tony Greening  
Chief Executive Officer

"Ian Franks"

Ian Franks  
Chief Financial Officer



MEYERS NORRIS PENNY LLP

**Auditors' Report**

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To the Shareholders of ESI Entertainment Systems Inc.

We have audited the consolidated balance sheets of ESI Entertainment Systems Inc. as at February 28, 2009 and the consolidated statements of operations, comprehensive loss and deficit and cash flows for the year then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at February 28, 2009 and the results of its operations and its cash flows for the year then ended in conformity with Canadian generally accepted accounting principles.

The consolidated financial statements as at and for the year ended February 29, 2008 were audited by other auditors, who expressed an opinion without reservation on these statements in their report dated May 28, 2008.

*Meyers Norris Penny LLP*

Surrey, Canada  
May 7, 2009

Chartered Accountants



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# ESI Entertainment Systems Inc.

## Consolidated Balance Sheets

(expressed in Canadian dollars)

Years Ended	February 28, 2009	February 29, 2008
<b>Assets</b>		
Cash and cash equivalents	\$ 909,785	\$ 3,042,463
Accounts receivable	1,100,023	1,111,215
Prepays and other	106,513	444,575
	<u>2,116,321</u>	<u>4,598,253</u>
Citadel processing accounts (Note 4)	2,958,565	1,219,205
Property and equipment (Note 5)	280,725	718,869
Deferred contract costs	696,234	1,116,461
	<u>\$ 6,051,845</u>	<u>\$ 7,652,788</u>
<b>Liabilities</b>		
Accounts payable and accrued liabilities	\$ 1,049,700	\$ 820,492
Loan Payable (Note 14)	2,564,704	-
Capital lease obligations	30,684	214,715
Deferred revenue	535,667	706,773
	<u>4,180,755</u>	<u>1,741,980</u>
Citadel processing liabilities (Note 4)	2,958,565	1,530,705
Deferred revenue	1,324,392	1,923,472
Capital lease obligations	-	30,684
	<u>8,463,712</u>	<u>5,226,841</u>
<b>Shareholders' Equity (Deficiency)</b>		
Capital stock (Note 8)	9,957,959	9,957,959
Warrants (Note 9)	-	5,926
Contributed surplus (Note 10)	4,328,885	4,092,247
Deficit	(16,698,711)	(11,630,185)
	<u>(2,411,867)</u>	<u>2,425,947</u>
	<u>\$ 6,051,845</u>	<u>\$ 7,652,788</u>

Nature and continuance of operations (Note 1)  
 Commitments and contingencies (Note 15)  
 Subsequent events (Note 17)

On behalf of the Board

"Tony Greening" Director  
**Tony Greening**

"Michael Meeks" Director  
**Michael Meeks**

**ESI Entertainment Systems Inc.**  
**Consolidated Statements of Operations and Comprehensive**  
**Loss and Deficit**  
**(expressed in Canadian dollars)**

Years Ended	February 28, 2009	February 29, 2008
Revenues (Note 7)	\$ 3,954,820	\$ 3,248,630
Direct costs	<u>2,983,798</u>	<u>2,730,208</u>
Gross profit	<u>971,022</u>	<u>518,422</u>
Operating expenses		
Product development	604,070	1,241,378
Sales, marketing and customer service	741,212	1,671,003
General and administrative	3,761,514	5,410,952
Amortization of property and equipment	453,205	776,706
Cost recovery (Note 1)	-	(2,055,430)
	<u>5,560,001</u>	<u>7,044,609</u>
Loss before under noted items	(4,588,979)	(6,526,187)
Other expenses (income)		
Impairment of intangibles and other assets (Notes 1 and 2)	-	57,192
Foreign exchange loss	383,641	837,685
Interest income	(41,536)	(297,751)
Interest expense	<u>128,913</u>	<u>49,845</u>
Loss before income taxes	<u>(5,059,997)</u>	<u>(7,173,158)</u>
Provision for income taxes (Note 12)	<u>8,529</u>	<u>27,243</u>
Net loss and comprehensive loss	<u>\$ (5,068,526)</u>	<u>\$ (7,200,401)</u>
Loss per share		
Basic and diluted	\$ (0.36)	\$ (0.42)
<hr/>		
Deficit, beginning of year	\$ (11,630,185)	\$ (4,429,784)
Net loss	<u>(5,068,526)</u>	<u>(7,200,401)</u>
Deficit and accumulated other comprehensive deficit, end of year	<u>\$ (16,698,711)</u>	<u>\$ (11,630,185)</u>
<hr/>		
Weighted average basic and diluted common shares outstanding	# 14,234,727	# 17,410,636

# ESI Entertainment Systems Inc.

## Consolidated Statements of Cash Flows

(expressed in Canadian dollars)

Years Ended	February 28, 2009	February 29, 2008
Cash flows provided by (used in)		
<b>Operating activities</b>		
Net loss	\$ (5,068,526)	\$ (7,200,401)
Items not affecting cash:		
Stock-based compensation (Note 11)	230,712	423,588
Amortization of property and equipment	453,205	776,706
Impairment of intangibles and other assets (Notes 1 and 2)	-	57,192
Net changes in non-cash operating items		
Accounts receivable	11,192	(460,152)
Prepays and other	338,062	(65,047)
Accounts payable and accrued liabilities	229,208	(479,564)
Allowance for bad debts (Note 1)	(311,500)	(496,000)
Deferred revenue	(770,186)	1,010,801
Deferred contract costs	420,227	(613,865)
	<u>(4,467,606)</u>	<u>(7,046,742)</u>
<b>Investing activities</b>		
Restricted cash	-	1,100,903
Acquisition of property and equipment	(15,061)	(103,811)
	<u>(15,061)</u>	<u>997,092</u>
<b>Financing activities</b>		
Capital lease payments	(214,715)	(348,671)
Software license obligation	-	(9,917)
Cancellation of common share costs	-	(3,000)
Loan payable	2,564,704	-
	<u>2,349,989</u>	<u>(361,588)</u>
Decrease in cash and cash equivalents	(2,132,678)	(6,411,238)
Cash and cash equivalents, beginning of year	<u>3,042,463</u>	<u>9,453,701</u>
Cash and cash equivalents, end of year	<u>\$ 909,785</u>	<u>\$ 3,042,463</u>

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# ESI Entertainment Systems Inc.

## Consolidated Statements of Cash Flows (Continued)

(expressed in Canadian dollars)

<b>Years Ended</b>	<b>February 28 2009</b>	<b>February 29 2008</b>
<b>Cash and cash equivalents comprises</b>		
Cash	\$ 909,785	\$ 3,042,354
Cash equivalents	-	109
	<u>\$ 909,785</u>	<u>\$ 3,042,463</u>
<b>Supplemental information</b>		
Interest received	\$ 41,536	\$ 71,977
Interest paid	\$ 128,913	\$ 25,432
Income taxes paid	\$ 8,529	\$ 27,243

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# ESI Entertainment Systems Inc.

## Notes to the Consolidated Financial Statements

(expressed in Canadian dollars)

Years Ended February 28, 2009 and February 29, 2008

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### 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.

The Company operates in two operating segments, "ESI Integrity" and "Citadel". These are autonomously operated with completely separate management and personnel.

ESI Integrity provides embedded 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 betting.

Citadel provides on-line payment processing services including electronic cheque, credit card and direct debit, with concurrent transactional fraud detection services including full identity pre-authorization via in-house and third party databases and validation of previous transaction history.

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 year ended February 28, 2009 the Company incurred a loss from operations of \$5,068,526 and a deficiency in operating cash flow of \$4,467,606. In addition, the Company has incurred significant operating losses and net utilization of cash in operations in all 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.

### Geopolitical risk and impact of legislation in the USA as it pertains to Citadel

Significant new legislation regarding on-line gambling was introduced and enacted in the USA during fiscal 2007. There has been no risk or impact of legislation in the USA to ESI Integrity. However the new legislation has considerably affected the Citadel Commerce business and the following notes deal solely with the impact on Citadel.

While Citadel does not operate a gaming business itself, its products and services were used by companies operating in the on-line gaming industry. Citadel had on-line gaming customers in Canada and the United States which have now been discontinued. Citadel is now expanding its customer base by processing for payments processors and for merchants outside the USA and Canada. The governments of each country approach the issue of online gaming quite differently.

In Canada, corporate counsel asserts that most on-line gaming is likely prohibited activity under the federal Criminal Code ("the Code"). However the issue is not addressed directly in the Code, nor is there Canadian case law that provides a definitive answer one way or the other. Therefore it is possible that the provision of on-line gaming services, such as those supplied by users of Citadel's products and services could constitute the carrying on of a prohibited activity in Canada. The prohibitions in the Code, together with the possibility that

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# ESI Entertainment Systems Inc.

## Notes to the Consolidated Financial Statements

(expressed in Canadian dollars)

Years Ended February 28, 2009 and February 29, 2008

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### 1. Nature and continuance of operations as it pertains to Citadel (Continued)

Citadel's activities could theoretically be found to constitute aiding and abetting in the commission of an offence, create risk for Citadel. However, as noted, there is little Canadian legislation or case law directly on point and so it is difficult if not impossible to accurately measure the level of such a risk. In fiscal 2008, the Company ceased processing payments directly for on-line gaming merchants in Canada, but continues to provide processing services to other third party processors

In the United States, President Bush signed the *Unlawful Internet Gambling Enforcement Act of 2006* (the "UIGEA") into force on October 13, 2006. The UIGEA represents an attempt by the U.S. government to stop non-domestic online gaming in the United States by cutting off the cash flow between U.S. online gamblers and non-domestic online gaming websites. This will be accomplished by developing policies and procedures for identifying and blocking all such transactions, and by requiring financial institutions (including companies such as Citadel) to adopt and follow those policies and procedures. Although the Company intended to comply with the policies and procedures once they are issued and known, the Company ceased its payment processing business for USA consumers on January 17, 2007 due to actions taken by Department of Justice against other financial processors' executives. The closure of this business segment has had a material impact on Citadel's business as approximately 95% of its fiscal 2007 revenues were derived from those merchants. This closure has not been treated as a discontinued operation as the Company cannot make realistic estimates of costs associated with these operations.

During March, 2007 the USA Department of Justice (DOJ) obtained a court order instructing Citadel's United States bank to freeze funds held in that bank. Subsequently, the DOJ compelled that same bank to disgorge all such funds to the DOJ.

During fiscal 2008 the Company was engaged in negotiations with the US District Attorney's Office for the Southern District of New York ("USDA") over its involvement, prior to January 17, 2007, as a financial processor to internet based gaming merchants providing services to US consumers. Those negotiations led to approval by the Court in New York of a Deferred Prosecution Agreement ("DPA") with a duration of 18 months which was finalized in June 2008. At the completion of the 18 month period, and subject to compliance with the terms of the DPA, the USDA will inform the court that it is dismissing the information previously filed with the court; there will be no prosecution of ESI and the case will be dismissed.

# ESI Entertainment Systems Inc.

## Notes to the Consolidated Financial Statements

(expressed in Canadian dollars)

Years Ended February 28, 2009 and February 29, 2008

### 1. Nature and continuance of operations as it pertains to Citadel (Continued)

The following table shows the change in Citadel processing accounts and Citadel processing liabilities for the fiscal year 2008.

	<b>Citadel Processing Accounts</b>	<b>Citadel Processing Liabilities</b>
Reserves	\$ 10,556,554	\$ 10,556,554
Other merchant funds	6,326,714	6,326,714
Provision for bad debts (Note 4)	<u>(807,500)</u>	<u>-</u>
Balance, February 28, 2007	16,075,768	16,883,268
Merchant reserves seized by DOJ	(7,105,524)	(7,105,524)
Citadel funds seized by DOJ	(1,866,634)	(1,866,634)
Recovery of provision previously allowed for	-	(496,000)
Recovery of costs	<u>(2,055,430)</u>	<u>(2,055,430)</u>
	5,048,180	5,359,680
Other reductions through lower volumes arising from the normal course of business and unrelated to DOJ	<u>(3,828,975)</u>	<u>(3,828,975)</u>
Balance, February 29, 2008	\$ <u>1,219,205</u>	\$ <u>1,530,705</u>

During fiscal 2008 the Company retained a firm of independent forensic accountants who determined that the funds seized by the DOJ included \$1,866,634 of Citadel's own funds (\$1,100,903 reported in fiscal 2007).

Before Citadel ceased processing entirely in the USA, it was determined the UIGEA would likely adversely impact the Company's Citadel business unit. In fiscal 2007 the Company undertook a review of its accounting treatment of assets including deferred start-up costs, capitalized development costs, inventory and property and equipment. The Company could not forecast with any certainty that it would recover the capitalized costs related to these assets and recorded an impairment charge in that year. In addition, the Company carried in prepaids a balance for software that had been partially installed in fiscal 2007, and as it can not determine with any certainty whether that software will be used in the future, it has recorded an impairment charge in fiscal 2008.

The Company is seeking to increase the volume of business it does with customers operating in jurisdictions where non-domestic online gaming is clearly legal, including the United Kingdom which announced legislation to license and regulate the on-line gaming industry. During the 2007 fiscal year, Citadel Commerce UK was authorized by the UK Financial Services Authority (FSA) as an ELMI (Electronic Money Issuer). The Company also obtained similar status throughout the European Union through the Passporting rules.

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# ESI Entertainment Systems Inc.

## Notes to the Consolidated Financial Statements

(expressed in Canadian dollars)

Years Ended February 28, 2009 and February 29, 2008

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### 1. Nature and continuance of operations as it pertains to Citadel (Continued)

Pursuant to the terms of the Company's agreements with its merchants, the merchants are obligated to indemnify the Company where the merchants' actions cause losses or damages to the Company. The Company has obtained a legal opinion that their merchants' actions were the cause of the DOJ seizure and as such, certain costs incurred by the Company are eligible for indemnification under the contractual terms of these merchant agreements. In management's opinion, costs eligible for indemnification include:

- previously written off development costs related to the Citadel business segment;
- costs associated with its software code license;
- certain general and administrative expenses; and
- the \$1,866,634 of the Company's own funds seized by the DOJ (see table above).

In aggregate, these costs totaled approximately \$7.6 million and were incurred in fiscal 2007 (\$6.4 million) and fiscal 2008 (\$1.2 million). Since merchant funds held by the Company and available to be used as indemnification totaled only \$2,055,430, this amount has been recorded as a cost recovery in the prior fiscal year with the balance included in expenses. The Company has not accrued for any indemnification in excess of this amount.

The Company may incur additional costs defending any challenge.

### 2. Summary of significant accounting policies

#### Basis of consolidation and financial statement preparation

The Company has consolidated all the assets, liabilities, revenues and expenses of all subsidiaries after elimination of inter-company transactions and balances. These consolidated financial statements include the accounts of the Company and the following direct and indirect subsidiaries:

- ESI Integrity Inc. - wholly-owned subsidiary incorporated in Canada
- Citadel Commerce Corp - wholly-owned subsidiary incorporated in Canada
- Fortress Commerce Corp. - wholly-owned subsidiary incorporated in British Columbia, Canada
- Playline, Inc. - wholly-owned subsidiary incorporated in Canada
- Citadel Commerce UK Limited - wholly-owned subsidiary incorporated in United Kingdom
- Citadel Commerce Costa Rica Holdings S.R.L - wholly-owned subsidiary incorporated in Costa Rica
- Citadel Commerce Holdings (Malta) Limited - wholly-owned subsidiary incorporated in Malta
- Citadel Commerce (Malta) Limited - wholly-owned subsidiary incorporated in Malta
- Fortress Technologies Limited - wholly-owned subsidiary incorporated in Malta
- Playline Technologies Limited - wholly-owned subsidiary incorporated in Malta
- Citadel Commerce Africa (PTY) Ltd. - wholly-owned subsidiary incorporated in South Africa
- CC Mexico Holdings, S. de R.L. de C.V. - wholly-owned subsidiary incorporated in Mexico

#### Cash and cash equivalents

All highly liquid investments with an original maturity date of three months or less at the date of purchase are classified as cash and cash equivalents.

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# ESI Entertainment Systems Inc.

## Notes to the Consolidated Financial Statements

(expressed in Canadian dollars)

Years Ended February 28, 2009 and February 29, 2008

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### 2. Summary of significant accounting policies (Continued)

#### Property and equipment

Property and equipment are recorded at cost less accumulated amortization. Amortization is calculated on a straight line basis at the following annual rates:

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

#### Deferred contract costs

Contract costs incurred for the installation of software pursuant to license agreements with ESI 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 ESI 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 net loss.

#### Leases

Leases that transfer substantially all the benefits and risk of ownership to the Company are recorded as capital leases. Assets under capital lease are included in property and equipment with offsetting long-term capital lease obligation being recorded as liabilities. All other leases are classified as operating leases under which lease costs are expensed in the period.

#### Financial Instruments

In accordance with the new CICA accounting standards 3855 and 3861, all financial instruments, including embedded derivatives, must initially be recognized at fair value on the balance sheet and classified into the following categories: financial assets and financial liabilities held for trading, held-to-maturity investments, loans and receivables, available-for-sale financial assets, and other financial liabilities. Subsequent measurements of the financial instruments are based on their classification. Unrealized gains and losses on held for trading financial instruments are recognized in earnings. Unrealized gains and losses on available-for-sale financial assets are recognized in other comprehensive income and are transferred to income when the instrument is settled. The other categories of financial instruments are recognized at amortized cost using the effective interest rate method. Investment transactions are made on the trade date and any transaction costs with respect to financial instruments are expensed in the period incurred.

The Company's financial instruments are listed as follows, according to their classification:

- a) Cash and cash equivalents are classified as held-for-trading and are measured at fair value;
- b) Accounts receivable is classified as loans and receivables and are measured at amortized cost;
- c) Accounts payable, accrued liabilities and loan payable are classified as other financial liabilities and are measured at amortized cost.

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# ESI Entertainment Systems Inc.

## Notes to the Consolidated Financial Statements

(expressed in Canadian dollars)

Years Ended February 28, 2009 and February 29, 2008

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### 2. Summary of significant accounting policies (Continued)

#### Comprehensive income

The components of other comprehensive income included unrealized gains and losses on financial assets classified as available-for-sale and the effective portion of cash flow hedges, if any. There were no such components to be recognized in comprehensive income upon transition or for the years ended February 28, 2009 and 2008. As the Company has no items of other comprehensive income or loss, the net earnings or loss for the periods are equivalent to comprehensive income.

#### Impairment of long-lived assets

Long-lived assets consist of property and equipment and deferred contract costs. Long-lived assets held for use are measured and amortized as described in the applicable accounting policies.

The Company performs impairment testing on long-lived assets held for use whenever events or changes in circumstances indicate that the carrying value of an asset, or group of assets, may not be recoverable. Impairment losses are recognized when undiscounted future cash flows from their use and disposal are less than the assets carrying amount.

Impairment is measured as the amount by which the assets' carrying value exceeds its fair value. Any impairment is included in loss for the year.

#### Revenue recognition

Revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable, and collection is reasonably assured at the time of recognition.

For ESI 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.

#### Stock-based compensation plans

The Company has adopted the recommendations of CICA Handbook Section 3870, "*Stock-Based Compensation and Other Stock-Based Payments*", which requires the fair value based method of accounting for all stock-based compensation earned during the year. The fair value of options granted to employees is estimated on the date of grant and is recognized as compensation expense over the vesting period of the options with a corresponding credit to contributed surplus. The contributed surplus balance is reduced as options are exercised and the amount initially recorded for the options in contributed surplus is credited to share capital.

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# ESI Entertainment Systems Inc.

## Notes to the Consolidated Financial Statements

(expressed in Canadian dollars)

Years Ended February 28, 2009 and February 29, 2008

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### 2. Summary of significant accounting policies (Continued)

#### Income taxes

The Company follows the asset and liability method of tax allocation accounting whereby future tax assets and liabilities are recognized for the future tax consequences attributable to temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases as well as utilized losses carried forward. Future tax assets and liabilities are measured using enacted or substantively enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on future tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the date of enactment or substantial enactment. The amount of future income tax assets recognized is limited to the amount that is estimated as more likely than not to be realized.

#### Translation of foreign currencies

The Company's functional currency is the Canadian dollar. The operations of the Company's subsidiaries are considered integrated and are translated using the temporal method. Transactions in foreign currencies are translated into Canadian dollars at the previous month's average exchange rate. Monetary assets and liabilities expressed in foreign currencies are translated to Canadian dollars at the exchange rates in effect at the balance sheet date. The resulting exchange gains and losses are recognized in income.

#### Loss per share

Basic loss per share is computed by dividing income available to common shareholders by the weighted average number of common shares outstanding during the period. The computation of diluted loss per share assumes the conversion, exercise or contingent issuance of securities only when such conversion, exercise or issuance would have a dilutive effect on loss per share. The diluted effect of outstanding options and warrants and their equivalents is reflected in diluted loss per share by the application of the treasury stock method. This method assumes the proceeds from the exercise of dilutive options and warrants are used to purchase common shares at the weighted average market price during the period.

#### Use of estimates and measurement uncertainty

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the period reported. Items requiring significant estimates and subject to measurement uncertainty include amortization on property and equipment, deferred contract costs, impairment allowance, valuation allowance against future tax assets, merchant and tax liabilities and stock based compensation expense. By their nature, these estimates are subject to measurement uncertainty. Actual results could differ, and such estimates may be subject to change in the future.

#### Recent Pronouncements in Accounting Standards

a) International Financial Reporting Standards ("IFRS")

The accounting framework under which financial statements are prepared in Canada for all publicly accountable enterprises is scheduled to change to International Financial

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# ESI Entertainment Systems Inc.

## Notes to the Consolidated Financial Statements

(expressed in Canadian dollars)

Years Ended February 28, 2009 and February 29, 2008

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### 2. Summary of significant accounting policies (Continued)

Reporting Standards ("IFRS") by January 1, 2011. Generally accepted accounting principles ("GAAP") will cease to apply and will be replaced by IFRS. Commencing in fiscal 2010, the Company will need to prepare accounts in accordance with Canadian GAAP and IFRS in order to have comparative financial statements on full implementation of IFRS in 2011.

b) Business combinations – Section 1582

Section 1582 specifies a number of changes including: an expanded definition of a business, a requirement to measure all business acquisitions at fair value, a requirement to measure non-controlling interests at fair value, and a requirement to recognize acquisition related costs as expenses. This standard becomes effective beginning on or after January 1, 2011, but earlier adoption is permitted. The Company is currently assessing the impact of this new standard.

c) Consolidated financial statements 1601/1602

Section 1601 establishes the standards for preparing consolidated financial statements. Section 1602 specifies that non-controlling interests be treated as a separate component of equity, not as a liability or other item outside of equity. This standard becomes effective beginning on or after January 1, 2011, but earlier adoption is permitted. The Company is currently assessing the impact of this new standard.

### 3. Changes in accounting policy

a) Capital disclosures, Section 1535

Effective March 1, 2008, the Company adopted Section 1535 "Capital Disclosures" which requires the disclosure of information that enables users of an entity's financial statements to evaluate its objectives, policies and processes for managing capital such as qualitative information about its objectives, policies and processes for managing capital, summary quantitative data about what the entity manages as capital, whether it has complied with any capital requirements and, if it has not complied, the consequences of non-compliance. Disclosures required by this standard are included in Note 18. The adoption of this standard did not have a material impact on the consolidated financial statements.

b) Financial Instruments Disclosures, Section 3862 / Financial Instruments Presentation, Section 3863

Effective March 1, 2008, the Company adopted Section 3862 "Financial Instruments – Disclosures" and Section 3863 "Financial Instruments – Presentation". These Sections require entities to provide disclosure of quantitative and qualitative information in their financial statements that enable users to evaluate (a) the significance of financial instruments for the entity's financial position and performance; and (b) the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the balance sheet date, and management's objectives, policies and procedures for managing such risks. Disclosures required by this standard are included in Note 16. The adoption of this section had no effect on the Company's financial statements.

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# ESI Entertainment Systems Inc.

## Notes to the Consolidated Financial Statements

(expressed in Canadian dollars)

Years Ended February 28, 2009 and February 29, 2008

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### 3. Changes in accounting policy (Continued)

c) Goodwill and intangible assets, Section 3064

Effective March 1, 2008 the Company adopted Section 3064 "Goodwill and intangible assets" replacing Section 3062 "Goodwill and intangible assets" and Section 3450 "Research and development costs". Section 3064 establishes standards for the recognition, measurement, presentation and disclosure of goodwill subsequent to its initial recognition and of intangible assets by profit-oriented enterprises. Standards concerning goodwill are unchanged from the standards included in the previous Section 3062. The adoption of this section had no effect on the Corporation's financial statements.

d) Going Concern - Amendments to Section 1400

Effective March 1, 2008 the Company adopted amendments to CICA 1400, General Standards of Financial Statements Presentation to include requirements to assess and disclose an entity's ability to continue as a going concern. The adoption of this section had no effect on the Corporation's financial statements.

e) Inventory, Section 3031

Effective March 1, 2008, the Company adopted the Canadian Institute of Chartered Accountants' new recommendation for inventory under CICA 3031 "Inventories". The new Section provides guidance on the measurement and disclosure of inventories. The new recommendation establishes that inventories should be measured at the lower of cost and net realizable value and provides guidance on the determination of cost. There was no material impact on the financial statements from the retrospective application of the new accounting recommendations.

### 4. Citadel processing

Citadel Processing Accounts represents the bank accounts maintained by the Company for the strict purpose of payment processing for Citadel merchants and clients. These accounts are separate 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. These amounts consist of:

	<u>2009</u>	<u>2008</u>
Merchant processing funds	\$ 2,403,348	\$ 1,001,619
Merchant reserves	56,690	138,450
Merchant payout funds	450,398	347,280
myCitadel consumer funds	<u>48,129</u>	<u>43,356</u>
	<u>\$ 2,958,565</u>	<u>\$ 1,530,705</u>

# ESI Entertainment Systems Inc.

## Notes to the Consolidated Financial Statements

(expressed in Canadian dollars)

Years Ended February 28, 2009 and February 29, 2008

### 4. Citadel processing (Continued)

Merchant processing funds are funds held with Citadel for 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.

Merchant payout funds relate to cash designated by merchants to fund player winnings.

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

### 5. Property and equipment

2009	<u>Cost</u>	<u>Accumulated Amortization</u>	<u>Net Book Value</u>
Computer hardware	\$ 1,252,146	\$ 1,189,556	\$ 62,590
Computer software	487,932	459,007	28,925
Furniture and fixtures	248,502	141,373	107,129
Leasehold improvements	346,457	292,429	54,028
Equipment under capital lease	<u>1,006,271</u>	<u>978,218</u>	<u>28,053</u>
	<u>\$ 3,341,308</u>	<u>\$ 3,060,583</u>	<u>\$ 280,725</u>
2008	<u>Cost</u>	<u>Accumulated Amortization</u>	<u>Net Book Value</u>
Computer hardware	\$ 1,252,586	\$ 1,059,886	\$ 192,700
Computer software	472,205	395,806	76,399
Furniture and fixtures	254,336	117,031	137,305
Leasehold improvements	346,457	222,176	124,281
Equipment under Capital lease	<u>1,006,271</u>	<u>818,087</u>	<u>188,184</u>
	<u>\$ 3,331,855</u>	<u>\$ 2,612,986</u>	<u>\$ 718,869</u>

### 6. Lease obligations

The company has equipment under capital lease obligations until September 2009. The monthly lease payments consist of principal repayment and interest and the imputed interest rates vary between 11.56% and 12.32%. The expected repayments over the next fiscal year are estimated to be \$30,684 with imputed interest of \$1,236.

# ESI Entertainment Systems Inc.

## Notes to the Consolidated Financial Statements

(expressed in Canadian dollars)

Years Ended February 28, 2009 and February 29, 2008

### 7. 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 betting.

Citadel provides on-line payment processing services including internet banking and electronic cheque, with concurrent transactional fraud detection services including pre-authorization via in-house and third party databases and validation of previous transaction history.

Included in “other” are the corporate activities including the Company’s indirect support costs for the two operating segments.

The segmented information for each business segment is as follows:

<b>2009</b>	<b>Citadel</b>	<b>ESI Integrity</b>	<b>Other</b>	<b>Consolidated</b>
Revenue	700,977	3,253,843	-	3,954,820
Direct Costs	858,987	2,124,811		2,983,798
Gross Profit (Loss)	(158,010)	1,129,032	-	971,022
Operating expenses	2,459,745	1,069,619	1,577,432	5,106,796
Amortization	309,884	42,593	100,728	453,205
(Loss) earnings before other income, expenses, and income taxes	(2,927,639)	16,820	(1,678,160)	(4,588,979)
Interest income	(40,085)	(101)	(1,350)	(41,536)
Interest expense	12,780	912	115,221	128,913
Foreign exchange	-	-	-	383,641
Provision for income taxes	-	-	-	8,529
Net loss	-	-	-	(5,068,526)
Property and equipment, net	163,199	29,801	87,725	280,725

<b>2008</b>	<b>Citadel</b>	<b>ESI Integrity</b>	<b>Other</b>	<b>Consolidated</b>
Revenue	875,291	2,373,339	-	3,248,630
Direct Costs	1,384,328	1,345,880		2,730,208
Gross Profit (Loss)	(509,037)	1,027,459	-	518,422
Operating expenses	3,631,939	1,785,911	850,053	6,267,903
Amortization of PP&E	652,083	116,803	7,820	776,706
(Loss) Earnings before other income, expenses, and income taxes	(4,793,059)	(875,255)	(857,873)	(6,526,187)
Interest income	(237,776)	(54,344)	(5,631)	(297,751)
Interest expense	42,955	3,260	3,630	49,845
Impairment	57,192			57,192
Foreign exchange	-	-	-	837,685
Provision for income taxes	-	-	-	27,243
Net loss	-	-	-	(7,200,401)
Property and equipment, net	471,467	71,128	176,274	718,869

# ESI Entertainment Systems Inc.

## Notes to the Consolidated Financial Statements

(expressed in Canadian dollars)

Years Ended February 28, 2009 and February 29, 2008

### 7. Segmented information (Continued)

#### Geographic location

The company's operations are conducted in three geographic segments: Canada, the USA and International.

Revenues earned by geographic location are as follows:

	<u>2009</u>	<u>2008</u>
United States	\$ 1,571,782	\$ 1,728,150
Canada	565,968	762,493
International	<u>1,817,070</u>	<u>757,987</u>
	<u>\$ 3,954,820</u>	<u>\$ 3,248,630</u>

As at February 28, 2009, 79% of the Company's fixed assets were situated in Canada and 21% were located internationally.

#### Economic dependence

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

	<u>2009</u>	<u>2008</u>
Customer A	20%	23%
Customer B	16%	16%
Customer C	14%	12%
Customer D	12%	-

### 8. 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, 2007	<u>19,008,333</u>	\$ <u>13,220,776</u>
Expiry of Warrants		78,708
Cancellation of Common Shares	(4,773,606)	(3,341,525)
Balance, February 29, 2008	<u>14,234,727</u>	\$ <u>9,957,959</u>
Balance February 29, 2009	<u>14,234,727</u>	\$ <u>9,957,959</u>

On August 30, 2007, the Company entered into an agreement with Royal Bank of Canada ("RBC") whereby RBC agreed to surrender up to a total of 4,773,606 common shares to the treasury of the Company for cancellation without compensation. That transaction was completed on October 24, 2007. The average per share amount on the date of the

# ESI Entertainment Systems Inc.

## Notes to the Consolidated Financial Statements

(expressed in Canadian dollars)

Years Ended February 28, 2009 and February 29, 2008

### 8. Capital stock (Continued)

transaction was \$0.70. Upon cancellation of the common shares, \$3,341,525 was removed from Capital Stock and credited to Contributed Surplus.

### 9. Warrants

	2009		2008	
	Number of warrants	Amount	Number of warrants	Amount
Global Warrants	-	-	26,000	5,926
	-	\$ -	26,000	\$ 5,926

In connection with a loan that was repaid in fiscal 2007, the Company granted the lender 26,000 non-transferable warrants ("Global Warrants") with each warrant entitling the lender to purchase a common share of the Company at a price of \$3.00 per common share. The Global Warrants were exercisable anytime after the closing date of the IPO and expired unexercised on March 30, 2008.

### 10. Contributed Surplus

	<b>Amount</b>
Balance, February 28, 2007	330,134
Stock option compensation expense	423,588
Cancellation of common shares held by RBC	3,341,525
Expenses related to cancellation of shares	<u>(3,000)</u>
Balance, February 29, 2008	4,092,247
Expiry of Warrants	5,926
Stock option compensation expense	<u>230,712</u>
Balance, February 28, 2009	4,328,885

### 11. Stock-based compensation plans

Under the Company's 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.

# ESI Entertainment Systems Inc.

## Notes to the Consolidated Financial Statements

(expressed in Canadian dollars)

Years Ended February 28, 2009 and February 29, 2008

### 11. Stock-based compensation plans (Continued)

During the fiscal years ended February 28, 2009 and February 29, 2008, common share incentive stock options were granted and exercised as follows:

	<u>Number of Shares Issuable on Exercise</u>	<u>Weighted Average Exercise Price</u>
Balance, February 28, 2007	1,489,000	1.07
Granted during the year	1,200,000	0.50
Expired during the year	(157,125)	0.78
Forfeited during the year	(607,125)	0.89
Balance, February 29, 2008	1,924,750	0.78
Granted during the year	775,000	0.26
Expired during the year	(369,250)	0.54
Forfeited during the year	(380,250)	0.52
Balance, February 28, 2009	1,950,250	0.64
Exercisable at February 28, 2009	<u>917,625</u>	<u>0.84</u>

All options granted carried exercise prices equal to the current trading price of common shares at the date of grant. The Company recorded a stock based compensation expense in the statement of operations of \$230,712 for the year ended February 28, 2009 (2008: \$423,588). This amount is included in General and administrative operating expenses.

The fair value of each option grant was estimated on the date of the grant using the Black-Scholes option pricing model with the following assumptions:

	<u>2009</u>	<u>2008</u>
Risk-free interest rate	2.83% to 3.35%	4.02% to 4.51%
Dividend yield	-	-
Expected life	2	10
Volatility	209% to 213%	138%

The fair value of the options granted during fiscal 2009 was \$206,250 (2008: \$585,250)

Common share incentive stock options outstanding at February 28, 2009 are summarized as follows:

<u>Exercise Price</u>	<u>Number of Shares Issuable on Exercise</u>	<u>Weighted Average Remaining Life (Years)</u>	<u>Number of Shares Issuable on Exercisable Options</u>
\$0.25	11,000	4.93	11,000
0.26	625,000	9.30	78,125
0.45	25,000	9.26	6,250
0.48	25,000	8.26	6,250
0.50	771,250	8.04	388,750
0.71	260,000	6.04	256,250
0.80	25,000	7.67	12,500
2.20	10,000	7.15	10,000
2.36	198,000	7.19	148,500
	<u>1,950,250</u>		<u>917,625</u>

# ESI Entertainment Systems Inc.

## Notes to the Consolidated Financial Statements

(expressed in Canadian dollars)

Years Ended February 28, 2009 and February 29, 2008

### 12. Income taxes

The Company is not in compliance with Canadian and foreign statutory requirements related to the filing of corporate tax returns, as corporate returns for the Company and its subsidiaries have not been filed. Thus, the following tax information is based on estimates.

The tax effects of temporary differences that give rise to significant portions of the future tax assets and future tax liabilities are as follows:

	<u>2009</u>	<u>2008</u>
Future income tax asset (liability)		
Property and equipment	\$ 68,000	\$ 43,000
Cumulative eligible capital	12,312	13,000
Deferred share issuance cost	270,542	341,000
Deferred start up cost and contract cost	(181,021)	(301,000)
Capital lease obligation	7,978	15,000
Non-capital losses carried forward	<u>3,705,059</u>	<u>2,637,000</u>
Total future income tax asset (liability)	3,882,870	2,748,000
Less valuation allowance	<u>(3,882,870)</u>	<u>(2,748,000)</u>
Net future income taxes	\$ <u>-</u>	\$ <u>-</u>

The Company has non-capital tax losses amounting to \$14,250,225 which are available to be carried forward to reduce taxable income in future years, and expire as follows:

2011	6,972
2015	1,011,966
2026	1,712,936
2027	553,365
2028	5,946,106
2029	<u>5,018,880</u>
	<u>\$ 14,250,225</u>

The provision for income taxes shown on the statements of operations differs from the amounts obtained by applying combined Canadian and British Columbia statutory rates to the earnings before taxes as follows:

	<u>2009</u>	<u>2008</u>
Loss before income taxes	\$ (5,059,997)	\$ (7,173,185)
Combined statutory rate	<u>29.0%</u>	<u>31.5%</u>
Expected income tax (recovery) expense based on the statutory rate	\$ (1,467,399)	\$ (2,257,048)
Stock – base compensation	66,907	133,430
Tax effect of previously unrecognized losses	-	363,486
Change in tax rates	245,898	674,190
Change in valuation allowance	1,134,869	971,000
Tax effect of permanent and other differences	<u>28,254</u>	<u>142,185</u>
	\$ <u>8,529</u>	\$ <u>27,243</u>

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# ESI Entertainment Systems Inc.

## Notes to the Consolidated Financial Statements

(expressed in Canadian dollars)

Years Ended February 28, 2009 and February 29, 2008

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### 13. Related party transactions

During the year ended February 28, 2009, the Company had no related party transactions. During the prior year, the Company paid consulting fees for advisory services to a company controlled by a former director totaling \$25,242.

### 14. Loan Payable

In June 2008, the Company secured a US \$2 million dollar loan bearing interest at the rate of 6% per annum. In April 2009, the agreement was amended to reflect new repayment terms, which are; US \$1,500,000 repayable on June 11, 2009 and the balance plus accrued interest due on December 11, 2009. 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.

### 15. Commitments and contingencies

- (a) The Company leases certain office premises and equipment under operating leases. The future minimum payments under these leases are as follows:

2010	\$	560,384
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- (b) The Company is subject to anti-money laundering ("AML") legislation in jurisdictions in which it operates or has operated. Management has implemented controls and procedures that it believes put the Company in compliance with all applicable AML rules and regulations.

It is possible that regulatory authorities may audit the Company systems and processes and assess monetary penalties for non-compliance which could be material; however, the likelihood and magnitude of any such assessments cannot be determined at this time.

- (c) The Company files separate tax returns for its Canadian subsidiaries that were not filed on an individual basis in years prior to fiscal 2006. 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.
- (d) On September 26, 2008 in the U.S. District Court, Middle District of Florida, Citadel Commerce Corp filed a demand for a jury trial against Cook Systems, LLC and Randolph V. Cook. Citadel claims that the defendants breached contractual obligations, including (i) denying Citadel Commerce's exclusive marketing rights, (ii) refusing to provide Citadel Commerce with the developed product, and (iii) attempting to sell its rights, duties, or obligations.

### 16. Financial instruments and concentration of risk

#### Fair values

The carrying values of cash and cash equivalents, accounts receivable, Citadel processing accounts, accounts payable and accrued liabilities and Citadel processing liabilities approximated their fair values due to their short-term nature.

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# ESI Entertainment Systems Inc.

## Notes to the Consolidated Financial Statements

(expressed in Canadian dollars)

Years Ended February 28, 2009 and February 29, 2008

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### 16. Financial instruments and concentration of risk (Continued)

The carrying value of the loan payable approximates its fair value as it is payable on demand or has a short-term to maturity.

#### Credit and chargeback 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.

The ageing of receivables at the reporting date was as follows (the ageing days relates to balances past due):

February 28, 2009	Total \$	Current and <30 days \$	30-60 days \$
Net trade receivables	458,909	344,349	114,560

#### 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.

At February 28, 2009, if the Canadian dollar had weakened 5% against other currencies, with all other variables held constant, after-tax net income for the year would have been \$64,680 lower. Conversely, if the Canadian dollar had strengthened 5% against other currencies, with all other variables held constant, after-tax net income would have been \$64,680 higher.

#### 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, loan payable and capital lease obligations. 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.

### 17. Subsequent events

In March 2009, Citadel Commerce UK Ltd. received approval from the FSA to downgrade from a large e-money authorization to a small e-money exemption.

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# ESI Entertainment Systems Inc.

## Notes to the Consolidated Financial Statements

(expressed in Canadian dollars)

Years Ended February 28, 2009 and February 29, 2008

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### 17. Subsequent events (Continued)

On March 31, 2009, the Company chose to voluntarily delist from the TSX. The Company applied to list its shares on the Canadian National Stock Exchange ("CNSX") and has been approved; the shares now trade on the CNSX under the symbol ESY.

### 18. Capital management

The company manages the following as capital:

	2009	2008
Capital stock	9,957,959	9,957,959
Warrants	-	5,926
Contributed Surplus	4,328,885	4,092,247
Deficit	(16,698,711)	(11,630,185)

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.