

**ID WATCHDOG, INC.**

**CONSOLIDATED INTERIM CONDENSED FINANCIAL STATEMENTS**

**NINE MONTHS ENDED SEPTEMBER 30, 2012 AND 2011**

The accompanying unaudited consolidated interim condensed financial statements have been prepared by and are the responsibility of the Company's management.

The Company's independent auditor has not performed a review of these financial statements in accordance with standards established by the Canadian Institute of Chartered Accountants for review of interim financial statements by an entity's auditor.

**ID WATCHDOG, INC.**

**CONSOLIDATED INTERIM CONDENSED FINANCIAL STATEMENTS**

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**ID WATCHDOG, INC.**  
**CONSOLIDATED INTERIM CONDENSED STATEMENTS OF FINANCIAL POSITION**  
**(Unaudited)**  
**(Expressed in U.S. Dollars)**

	<u>September 30,</u> <u>2012</u>	<u>December 31,</u> <u>2011</u>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents .....	\$ 685,781	\$ 854,688
Available for sale securities.....	—	735,000
Accounts receivable, net of allowance of \$6,472 and \$6,472, respectively .....	90,320	109,591
Prepaid expenses and other .....	39,973	52,901
Total current assets .....	<u>816,074</u>	<u>1,752,180</u>
Property and equipment, net (Note 4) .....	175,549	238,658
Total assets .....	<u>\$ 991,623</u>	<u>\$ 1,990,838</u>
<b>LIABILITIES</b>		
Current liabilities:		
Accounts payable .....	\$ 364,423	\$ 357,689
Accrued liabilities .....	162,892	107,350
Current portion of finance lease obligations (Note 6) .....	14,014	15,600
Deferred revenue.....	282,087	215,200
Total current liabilities .....	<u>823,416</u>	<u>695,839</u>
Deferred Rent .....	90,734	91,919
Finance lease obligations, net of current portion (Note 6) .....	48,127	58,449
Series C Preferred mandatorily redeemable preferred shares, net of discount and conversion feature (Note 7) .....	2,710,254	2,204,390
Warrants (Note 11) .....	240,444	624,602
Total liabilities .....	<u>3,912,975</u>	<u>3,675,199</u>
Commitments and Contingencies .....		
<b>SHAREHOLDERS' DEFICIT</b>		
Share capital (Note 7, 9, 10, 11 and 12):		
Preferred shares; 450,000,000 shares authorized		
Ordinary shares; no par value; 450,000,000 shares authorized:		
Ordinary Shares .....	24,542,696	24,470,534
Contributed Surplus.....	1,886,267	1,440,371
Warrants .....	1,576,765	1,571,121
Accumulated deficit .....	(30,927,080)	(29,166,387)
Total shareholders' deficit .....	<u>(2,921,352)</u>	<u>(1,684,361)</u>
Total liabilities and shareholders' deficit .....	<u>\$ 991,623</u>	<u>\$ 1,990,838</u>

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

**ID WATCHDOG, INC.**  
**CONSOLIDATED INTERIM CONDENSED STATEMENTS OF OPERATIONS**  
(Unaudited)  
(Expressed in U.S. Dollars)

	<u>Three months ended</u> <u>September 30,</u>		<u>Nine months ended</u> <u>September 30,</u>	
	<u>2012</u>	<u>2011</u>	<u>2012</u>	<u>2011</u>
Revenue .....	\$ 434,052	\$ 446,817	\$ 1,348,429	\$ 1,542,511
Cost of revenue .....	<u>261,583</u>	<u>302,118</u>	<u>847,312</u>	<u>651,437</u>
Gross profit.....	172,469	144,699	501,117	891,074
Operating expense:				
General and administrative expense .....	277,087	415,569	1,131,101	1,637,136
Sales and Marketing expense .....	235,847	195,148	449,026	454,827
Stock – based compensation expense ....	103,725	242,647	445,896	612,445
Depreciation and amortization expense .....	<u>21,937</u>	<u>68,381</u>	<u>68,835</u>	<u>143,521</u>
	638,596	921,745	2,094,858	2,847,929
Operating loss .....	(466,127)	(777,046)	(1,593,741)	(1,956,855)
Other income (expense):				
Gain (loss) on warrant liability (Note 11)	3,639	1,668,000	384,158	(636,000)
Interest income.....	400	1,133	5,011	3,527
Interest expense.....	<u>(184,902)</u>	<u>(182,913)</u>	<u>(556,121)</u>	<u>(508,413)</u>
	(180,863)	1,486,220	(166,952)	(1,140,886)
Net income (loss) and comprehensive income (loss) applicable to ordinary shares.....	<u>\$ (646,990)</u>	<u>\$ 709,174</u>	<u>\$ (1,760,693)</u>	<u>\$ (3,097,741)</u>
Basic net income (loss) per share applicable to ordinary shares.....	<u>\$ (0.01)</u>	<u>\$ 0.01</u>	<u>\$ (0.01)</u>	<u>\$ (0.03)</u>
Weighted average number of shares outstanding - basic (Note 3) .....	<u>118,834,997</u>	<u>101,348,330</u>	<u>118,537,114</u>	<u>93,605,574</u>
Diluted net income (loss) per share applicable to ordinary shares.....	<u>\$ (0.01)</u>	<u>\$ 0.00</u>	<u>\$ (0.01)</u>	<u>\$ (0.03)</u>
Weighted average number of shares outstanding - diluted Note (3) .....	<u>118,834,997</u>	<u>156,188,427</u>	<u>118,537,114</u>	<u>93,605,574</u>

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

**ID WATCHDOG, INC.**  
**NOTES TO CONSOLIDATED INTERIM CONDENSED STATEMENTS OF SHAREHOLDERS' DEFICIT**  
**(Unaudited)**  
**(Expressed in U.S. Dollars)**

**Nine Months Ended September 30, 2011**

	<u>Ordinary Shares</u>	<u>Ordinary Shares Amount</u>	<u>Contributed Surplus</u>	<u>Warrants</u>	<u>Accumulated Deficit</u>	<u>Total Shareholders' Deficit</u>
Balances December 31, 2010	62,916,107	\$ 19,573,146	\$ 665,818	\$1,018,582	(\$ 26,552,846)	(\$ 5,295,300)
Net loss.....	—	—	—	—	(3,097,741)	(3,097,741)
Share based compensation expense and stock options issued for services.....	—	—	612,445	—	—	612,445
Shares issued in exchange of \$3,028,879 of the 2009 and 2010 convertible notes at \$0.10 per share, net of issuance costs.....	30,288,769	2,797,559	—	—	—	2,797,559
Shares issued in exchange of \$814,345 trade payable debt at \$0.10 per share, net of issuance costs.....	8,143,454	737,489	—	—	—	737,489
Series C Preferred conversion feature, net of issuance costs.....	—	106,233	—	—	—	106,233
Balances September 30, 2011.....	<u>101,348,330</u>	<u>\$ 23,214,427</u>	<u>\$ 1,278,263</u>	<u>\$1,018,582</u>	<u>(\$ 29,650,587)</u>	<u>(\$ 4,139,315)</u>

**Nine Months Ended September 30, 2012**

	<u>Ordinary Shares</u>	<u>Ordinary Shares Amount</u>	<u>Contributed Surplus</u>	<u>Warrants</u>	<u>Accumulated Deficit</u>	<u>Total Shareholders' Deficit</u>
Balances December 31, 2011	118,014,997	\$ 24,470,534	\$ 1,440,371	\$1,571,121	(\$ 29,166,387)	(\$ 1,684,361)
Net loss.....	—	—	—	—	(1,760,693)	(1,760,693)
Share based compensation expense and stock options issued for services.....	—	—	445,896	—	—	445,896
Shares and warrants issued in exchange of \$38,400 trade payable debt, net of issuance costs (Note 12).....	320,000	31,985	—	5,644	—	37,629
Ordinary Shares issued upon conversion of 50 Series C Preferred Shares.....	500,000	40,177	—	—	—	40,177
Balance, September 30, 2012.....	<u>118,834,997</u>	<u>\$ 24,542,696</u>	<u>\$ 1,886,267</u>	<u>\$1,576,765</u>	<u>(\$ 30,927,080)</u>	<u>(\$ 2,921,352)</u>

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**ID WATCHDOG, INC.**  
**NOTES TO CONSOLIDATED INTERIM CONDENSED STATEMENTS OF CASH FLOWS**  
**(Unaudited)**  
**(Expressed in U.S. Dollars)**

	<b>Nine Months Ended September 30,</b>	
	<b>2012</b>	<b>2011</b>
Cash flows from operating activities:		
Net loss .....	\$ (1,760,693)	\$ (3,097,741)
Adjustment to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization expense .....	68,835	143,521
(Gain) loss on fair value adjustments to warrant liabilities...	(384,158)	636,000
Interest expense-accrued dividends on Series C Preferred shares and amortization of liquidation preference, discount on warrants and debt offering costs.....	546,041	438,595
Share-based compensation expense to employees, directors and consultants.....	445,896	612,445
Issuance of ordinary shares in payment of interest.....	—	96,097
Changes in assets and liabilities:		
Decrease (increase) in accounts receivable .....	19,271	(9,419)
Decrease in prepaid expenses and other .....	11,777	61,548
Allowance for uncollectible note receivable.....	1,151	—
Increase (decrease) in deferred revenue .....	66,887	(124,365)
Increase (decrease) in deferred rent.....	(1,185)	8,409
Increase (decrease) in accounts payable and accrued liabilities.....	100,676	(733,384)
Net cash used in operating activities .....	(885,502)	(1,968,294)
Cash flows from investing activities:		
Sales of available-for-sale securities.....	735,000	—
Change in restricted cash.....	—	61,057
Capital expenditures .....	(5,726)	(50,102)
Net cash from investing activities .....	729,274	10,955
Cash flows from financing activities:		
Proceeds from issuance of Series C convertible preferred shares and warrants, net.....	—	2,685,776
Issuance costs related to conversion of debt and trade payables into ordinary shares .....	(771)	(267,796)
Repayment of debt .....	—	(271,100)
Repayment of finance lease obligations .....	(11,908)	(3,464)
Net cash (used in) provided by financing activities .....	(12,679)	2,143,416
Net increase (decrease) in cash .....	\$ (168,907)	\$ 186,077
Cash and cash equivalents, beginning of period .....	854,688	99,082
Cash and cash equivalents, end of period .....	\$ 685,781	\$ 285,159
Supplemental disclosure of cash flow information:		
Cash paid for interest .....	\$ 10,080	\$ 457,609
Supplemental disclosure of non-cash investing and financing activities:		
Ordinary shares and warrants issued upon the conversion of debt and accounts payable .....	\$ 38,400	\$ 3,747,125
Equipment acquired with financing leases.....	\$ —	\$ 75,169

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**ID WATCHDOG, INC.**  
**NOTES TO CONSOLIDATED INTERIM CONDENSED FINANCIAL STATEMENTS**  
**(Unaudited)**  
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## **1. General Business Description and Liquidity**

### **Business Description**

ID Watchdog, Inc. ("ID Watchdog" or the "Company") provides a variety of identity theft detection and resolution services primarily to individual consumers on a subscription basis, through its wholly owned subsidiary, Identity Rehab Corporation ("ID Rehab"). The Company's address is 621 17th Street, Suite 600, Denver, CO 80293.

ID Watchdog is a limited liability exempted company incorporated on May 13, 2008, under the laws of the Cayman Islands.

The Company's ordinary shares are listed on the TSX Venture Exchange (the "TSXV") trading under the symbol "IDW".

The accompanying consolidated financial statements include the results of operations of the Company and those of those of its wholly owned subsidiaries ID Rehab and WDI Processing, LLC.

### **Liquidity**

The Company has incurred significant losses from operations and has funded these losses primarily through funds raised in its Initial Public Offering ("IPO") in 2008 and from private placements of debt and equity securities.

On February 24, 2011, the Company completed a recapitalization of the Company (the "Recapitalization"), in which it raised \$2,816,897 in net proceeds from the sale of preferred stock, retired \$2,932,780 of debt in exchange for ordinary shares in the Company (the "Ordinary Shares") and repaid \$814,445 of trade payables in exchange for Ordinary Shares. The details of the Recapitalization activities are as follows:

- The sale of 3,123,481 shares of Series C Preferred (as defined below) as a part of units, at a price of \$1,000 per unit, with each unit consisting of one (1) Series C Convertible Preferred share of no par value (the "Series C Preferred") and 5,000 warrants to purchase Ordinary Shares (the "Recap Warrants") (each one share of Series C Preferred and 5,000 warrants a "Recap Unit" and collectively the "Recap Units"). The gross proceeds from the sale of the Recap Units were \$3,123,481. Each Series C Preferred Share is convertible into 10,000 Ordinary Shares in the capital of the Company at a conversion price of \$0.10 per share at any time before February 24, 2016. The Series C Preferred Shares mature on February 24, 2016 and may be repaid in cash or through the issuance of a 90-day promissory note on the maturity date. Each Recap Warrant is exercisable into one Ordinary Share in the capital of the Company at a price of \$0.12 at any time before February 24, 2016. The Recap Warrants are, at the option of the holder, exercisable on a cashless basis whereby the holder of the warrant will be entitled to receive that number of Ordinary Shares equivalent to the "in-the-money" value of the warrant divided by a minimum exercise price of \$0.12.
- The issuance of 30,288,769 Ordinary Shares, for repayment of \$2,932,780 face amount of outstanding convertible notes. The convertible notes consisted of \$1,703,000 of notes issued in October and November of 2009 maturing in September 2010 (the "2009 Notes") and \$1,500,000 of convertible notes (the "2010 Notes") outstanding with an extended maturity to February 2011. During the first quarter of 2011, a consent offer was made to the holders of the 2009 Notes and the 2010 Notes to exchange their notes for cash and Ordinary Shares. For

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each \$1,000 original face amount of 2009 Note and the 2010 Notes, the holders received \$200 in cash and that number of shares of our Ordinary Shares which is equal to the sum of \$1,000 plus applicable accrued interest thereon as of the closing of the offer, divided by \$0.10. Holders of \$271,100 face amount of the 2009 Notes and the 2010 Notes chose not to participate in the exchange and were repaid in cash. As of February 24, 2011, all of the 2009 and 2010 Notes had been repaid.

- The Company repaid \$814,345 of certain trade payables through the issuance of 8,143,450 Ordinary Shares (the "Vendor Ordinary Shares") at an issuance price of \$0.10 per Ordinary Share.
- The Company paid the placement agent and other financial advisors \$412,186 and issued 4,373,481 of warrants each exercisable into one Ordinary Share in the capital of the Company at a price of \$.12 per warrant. The warrants can be exercised at any time before February 24, 2016. In addition, the Company incurred \$118,020 of inducement fees and expenses to assist with the convertibles notes and trade payables exchanges described above.

On November 8, 2011, the Company closed a private placement offering of units (the "Units"). The Company sold 8,333,333 Units at a price of \$0.24 per Unit for aggregate gross proceeds of U.S. \$2,000,000 (the "Units Offering"). Net proceeds from the Units Offering were \$1,808,646. Each Unit consists of two Ordinary Shares in the capital of the Company and two ordinary share purchase warrants (each, a "Warrant"). The first Warrant entitles the holder to purchase one additional Ordinary Share at a price of U.S. \$0.15 at any time prior to 5:00 p.m. on November 8, 2016. The second Warrant entitles the holder to purchase one additional Ordinary Share at a price of U.S. \$0.25 at any time prior to 5:00 p.m. on November 8, 2016.

The Company has partnered with certain anti-virus and other desk-top software providers to provide our identity theft protection services as a complimentary add-on product offering directly to the partners' end-users through their customers' desktops (the "Desktop Partnering Strategy"). The Company began to implement the Desktop Partnering Strategy in early 2011 and, to date; we have not generated a meaningful number of customers or revenues from the Desktop Partnering Strategy. Further, the early results from the July 2012 launch of a significant anti-virus software provider have been substantially below our expectations.

The Company believes that it will require several additional quarters in working closely with each desktop software partner to reach a substantial portion of our partners' end-users and to effectively integrate our service offerings with their software products before we begin to generate meaningful customer registrations and ultimately new paying customers. However, the Company continues to experience lengthy delays in the deployment and integration of changes and optimization features and limited access to our partners' end-users and therefore there can be no assurance that our anti-virus and desktop publishing partners will continue to make programming resources available to implement the integration and optimization features we believe are necessary or that the Company will be successful over the long-term in generating any significant revenue from its Desktop Partnering Strategy.

The Company continues to make solid progress in expanding its network of employee benefit brokers who market our services to their employer clients for inclusion in the client's employee benefit plans as a voluntary employee benefit. However, we do not believe we will generate significant revenues from these sources until early 2013.

Our cash balances and as of September 30, 2012 were \$685,781. We are dependent upon our existing cash balances, along with our cash flow generated from gross profits and/ or additional debt or equity financing to fund our operating activities, our expansion plans and other working capital needs.



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The Company believes that it will likely achieve positive operating income in the second quarter of 2013. We anticipate modest sequential revenue growth beginning in the fourth quarter of 2012 and continuing through 2013, driven by growth from both our employee benefits channel and our anti-virus/tech support channel.

On November 19, 2012, the Company entered into a new two year agreement with one of its data provider, which becomes effective on January 1, 2013, requires the Company to pay a monthly fee equal to the greater of actual data usage priced at the contractual rates or \$10,000 and terminates the existing data agreements with this provider effective December 31, 2012. This new data agreement reduces our minimum payment for these data services by \$40,000 per month beginning January 1, 2013. As a result, our gross margins are projected to improve from 39.7% in the third quarter of 2012 to a range of 65% to 70% beginning in the first quarter of 2013.

We further reduced our operating costs in the fourth quarter of 2012, primarily by reducing personnel and adjusting the compensation levels of certain employees. To further improve our financial flexibility we are actively seeking a secured credit facility and we are in the early stages of discussions with potential lenders for this facility. While we believe we will likely be successful in these efforts, there can be no assurance we will be successful in securing a credit facility or on terms that would be acceptable to the Company.

Should the Company fall short of its projected revenue forecast and be unable to secure a credit facility or other financing in a timely fashion, we will likely need to take additional measures to reduce our operating costs and improve our working capital position. While we believe we can reduce costs to achieve positive operating cash flow in the short-term, given our current level of revenue, further cost reductions may limit our ability to grow our revenue, both in the short and long-term.

## **2. Significant Accounting Policies and Basis of Presentation**

### **(a) Statement of Compliance**

The consolidated financial statements of the Company have been prepared under International Financial Reporting Standards ("IFRS"). The financial statements have been prepared in accordance with International Accounting Standards 34 "Interim Financial Reporting."

The accounting policies used in these consolidated interim condensed financial statements are consistent with those used in the preparation of the December 31, 2011 audited financial statements.

These consolidated financial statements were authorized for issue by the Audit Committee of the Board of Directors on November 26, 2012.

### **(b) Basis of Measurement**

These consolidated financial statements have been prepared on a going concern basis using the historical cost convention, except as disclosed in the accounting policies below.

### **(c) Functional and Presentation Currency**

These consolidated financial statements are presented in U. S. dollars which is the Company's functional currency.

### **(d) Recent Accounting Pronouncements**

The IASB issued a number of new and revised Internal Accounting Standards, International Financial Reporting Standards, amendments and related interpretations which are effective for the

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Company's financial year beginning on or after January 1, 2012, For the purpose of preparing and presenting the financial information for the relevant periods, the Company has consistently adopted all these new standards for the relevant reporting periods.

At the date of authorization of these consolidated financial statements, the IASB and IFRIC has issued the following new and revised Standards and Interpretations which are not yet effective for the relevant reporting periods:

- IFRS 9, Financial Instruments, addresses the classification and measurement of financial assets;
- IFRS 10, Consolidated Financial Statements, builds on existing principles and standards and identifies the concept of control as the determining factor in whether an entity should be included within the consolidated financial statements of the parent company;
- IFRS 11, Joint Arrangements, establishes the principles for financial reporting by entities when they have an interest in arrangements that are jointly controlled;
- IFRS 12, Disclosure of Interest in Other Entities, provides the disclosure requirements for interest held in other entities including joint arrangements, associates, special purpose entities and other off interim condensed consolidated financial statements entities;
- IFRS 13, Fair Value Measurement defines fair value, establishes a single source for determining fair value and introduces consistent requirements for disclosure relating to fair value measurements;
- IAS 27, Separate Financial Statements, revised the existing standard which addresses the presentation of parent company financial statements that are not consolidated financial statements; and
- IAS 28, Investments in Associates and Joint Ventures, revised the existing standard and prescribes the accounting for investments and sets out the requirements for the application of the equity method when accounting for investments in associates and joint ventures.
- IAS 32, Financial Instruments: Presentation, amendments to IAS 32 provide specific guidance for when an entity can offset financial assets and liabilities by clarifying when a legally enforceable right to do so exists, and when an entity meets the criterion for the intent to settle on a net basis. These amendments are effective for annual periods beginning after January 1, 2014.
- Only IFRS 9, IFRS 10 and IFRS 13 are applicable to the Company, and will become mandatory for the Company on January 1, 2013. The Company has not yet assessed the impact of the standards or determined whether it will adopt any of the standards early.

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**3. Significant Accounting Policies**

The following is a summary of significant accounting policies used in the preparation of these consolidated financial statements.

**(a) Principles of Consolidation**

The consolidated financial statements include the accounts of ID Watchdog and its wholly-owned subsidiaries ID Rehab and WDI Processing, LLC. All significant intercompany accounts and transactions have been eliminated in consolidation.

**(b) Cash and Cash Equivalents**

Cash and cash equivalents are highly liquid investments that consist primarily of short-term money market instruments with maturities of 90 days or less at the time of the date of the statement of financial position. We utilize and invest with financial institutions that are sound and of high credit quality. Our investments are in low-risk instruments and we limit our credit risk exposure in any one institution or type of investment instrument in accordance with the Company's investment policy criteria which includes consideration of the credit worthiness of the institution. At times, cash balances in these accounts may exceed federally insured limits.

**(c) Available for Sale Securities**

Available for sale securities are short-term, highly liquid investments that are readily convertible to known amount of cash and which are subject to an insignificant risk of changes in value with a maturity of more than 90 days from the date of the statement of financial position as available-for-sale securities.

**(d) Property and Equipment**

(i) Recognition and measurement

Items of property and equipment are measured at cost less accumulated depreciation and accumulated impairment losses, if any. The cost consists of the purchase price, and any costs directly attributable to bringing the asset to the location and condition for its intended use.

When parts of an item of property and equipment have different useful lives, they are accounted for as separate items (major components) of property and equipment.

Gains and losses on disposal of an item of property and equipment are determined by comparing the proceeds from disposal with the carrying amount of property and equipment, and are recognized within other income in profit or loss.

(ii) Depreciation and Amortization

Furniture, equipment, leasehold improvements, computer hardware and computer software are stated at cost and are depreciated or amortized using the straight-line method over the estimated useful lives of the assets ranging from three to five years.

Depreciation methods, useful lives and residual values are reviewed at each financial year end and adjusted if appropriate.

**(e) Intangible Assets**

(i) Internal use software development costs

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Certain costs incurred in connection with the development of software to be used internally or for providing services to customers are capitalized once a project has progressed beyond a conceptual, preliminary stage to that of application development. Development costs that are directly attributable to the design and testing of identifiable software products controlled by the Company are recognized as intangible assets when the following criteria are met:

- It is technically feasible to complete the software products so that it will be available for use;
- Management intends to complete the software product and use or sell it;
- There is an ability to use or sell the software product;
- It can be demonstrated how the software product will generate probably future economic benefits;
- Adequate technical, financial and other resources to complete the development and to use or sell the software products are available; and
- the expenditure attributable to the software product during its development can be reliably measured.

Development costs that qualify for capitalization include both internal and external costs, but are limited to those that are directly related to the specific product. The capitalized development costs are measured at cost less accumulated amortization and accumulated impairment losses. Subsequent expenditure is capitalized only when it increased the future economic benefits embodied in the specific asset to which it relates. All other expenditures, including expenditures on internally generated goodwill and brands, is recognized in profit or loss as incurred.

(ii) Amortization

The company's registered trademarks have been determined to have an indefinite life and are therefore not amortized.

Internal use software development costs are amortized on a straight-line basis over three years.

Amortization methods, useful lives and residual values are reviewed at each financial year end and adjusted if appropriate.

**(f) Ordinary Shares**

Ordinary shares are classified as equity. Incremental costs directly attributable to the issuance of ordinary shares and share options are recognized as a deduction from equity, net of any tax effects.

**(g) Leases**

Leases that transfer substantially all of the benefits and risks of ownership to the Company are accounted for at the commencement of the lease term as finance leases and recorded as property and equipment at the fair value of the leased asset, or, if lesser, at the present value of the minimum lease payments, together with an offsetting liability.

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Finance charges are allocated to each period so as to achieve a constant rate of interest on the remaining balance of the liability and are charged directly against income. Capitalized leased assets are depreciated over the shorter of the estimated useful life of the asset or the lease term. All other leases are accounted for as operating leases and the lease costs are expensed as incurred.

**(h) Transaction Costs**

When the financial liability is not carried at fair value through income, transaction costs are deducted from the carrying value of the financial liability and are amortized over the life of the related debt instrument using the straight-line method which approximates the effective interest method. The amortization of the transaction costs, are included in interest expense in the consolidated statements of operations. When debt is repaid or settled prior to its maturity date, the write-off of the remaining unamortized debt offering costs is also reported as interest expense.

Transaction costs are expensed when incurred when the financial liability is carried at fair value.

**(i) Impairment of Long-lived Assets**

Property, equipment and intangible assets are tested for impairment when events or changes in circumstances indicate that the carrying amount may not be recoverable. Long-lived assets that are not amortized or that are not yet available for use are subject to an annual impairment test. For the purpose of measuring recoverable amounts, assets are grouped at the lowest levels for which there are separately identifiable cash flows (cash-generating units or CGUs). The recoverable amount is the higher of the asset's fair value less costs to sell and value in use (being the present value of the expected future cash flows of the relevant asset or CGU). An impairment loss is recognized for the amount by which the asset's carrying amount exceeds its recoverable amount.

The Company evaluates impairment losses for potential reversals when events or circumstances, warrants such consideration.

**(j) Financial Instruments**

*(i) Classification and measurement*

Financial instruments are measured at fair value on initial recognition of the instrument. Measurement in subsequent periods depends on whether the financial instrument has been classified as "fair value through the statement of income", "loans and receivables", "available-for-sale", "held-to-maturity", or "financial liabilities measured at amortized cost" as defined by IAS 39, "Financial Instruments: Recognition and Measurement".

Financial assets and financial liabilities at "fair value through the statement of income" are either classified as "held for trading" or "designated at fair value through the statement of income" and are measured at fair value with changes in fair value recognized in the income statement. Transaction costs are expensed when incurred. The Company has designated cash and cash equivalents and available-for-sale securities "held for trading".

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Financial assets and financial liabilities classified as “loans and receivables”, “held-to-maturity”, or “financial liabilities measured at amortized cost” are measured at amortized cost using the effective interest method of amortization. “Loans and receivables” are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. Loans and receivables are initially recognized at the amount expected to be received, less, when material, a discount to reduce the loans and receivables to fair value. Subsequently, loans and receivables are measured at amortized cost using the effective interest method less a provision for impairment. “Held-to-maturity” financial assets are non-derivative investments that an entity has the positive intention and ability to hold to maturity. “Financial liabilities measured at amortized cost” are those financial liabilities that are not designated as “fair value through the statement of income” and that are not derivatives. The Company has designated accounts receivable as “loans and receivables” and accounts payable, accrued liabilities, capital lease obligations and convertible instruments as “financial liabilities measured at amortized cost”. Convertible instruments are initially recognized with the liability component being recorded at fair value, net of any transactions costs, and the equity conversion feature recorded as the residual amount and recognized in equity.

Financial liabilities are classified as current liabilities if payment is due within twelve months. Otherwise, they are presented as non-current liabilities.

(ii) Impairment

The Company assesses, as of each date of its statement of financial position, whether there is objective evidence that financial assets, other than those designated as “fair value through the statement of income” are impaired. When impairment has occurred, the cumulative loss is recognized in the statement of income. For financial assets carried at amortized cost, the amount of the impairment loss recognized is the difference between the asset’s carrying amount and the present value of estimated future cash flows, discounted at the financial asset’s original effective interest rate. When an available-for-sale financial asset is considered to be impaired, cumulative gains or losses previously recognized in other comprehensive income are reclassified to the statement of income in the period. Impairment losses may be reversed in subsequent periods.

**(k) Warrants**

The Company has issued warrants to purchase ordinary shares as described in Notes 7, 11 and 12. Warrants are valued using a fair value based method, whereby the fair value of the warrant is determined at the warrant issue date using a market-based option valuation model.

**(l) Revenue Recognition**

The Company’s services are offered to consumers primarily on a monthly subscription basis. Subscription fees are generally billed directly to the subscriber’s credit card or demand deposit account. At times, as a means of allowing customers to become familiar with the Company’s services, the Company offers free trial periods. No revenue is recognized until these applicable periods are completed.

Revenue for annual and multi-year subscription fees is deferred and recognized on a straight-line basis over a period which is equal to the standard monthly subscription rate for the time period calculated by using the subscription fee divided by the standard monthly subscription rate. Deferred revenue was \$282,087 and \$215,200 at September 30, 2012 and December 31, 2011, respectively, and is included in liabilities on the consolidated financial statements.

In addition, the Company has established a reserve for charge-backs and discretionary refunds

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based on actual experience. This reserve was \$2,291 and \$2,186 at September 30, 2012 and December 31, 2011, respectively, and is included in accrued liabilities on the consolidated financial statements.

**(m) Share Based Compensation**

The Company has one share-based compensation plan which is described in Note 9. The Company accounts for share-based awards that are settled through the issuance of equity using a fair value based method, whereby the fair value of the share-based award is determined at the date of grant using a market-based option valuation model. Stock-based compensation costs are expensed over the vesting period with a corresponding increase in contributed surplus. When stock options are exercised, the cash proceeds along with the amount previously recorded as contributed surplus are recorded as share capital. A forfeiture rate is estimated on the grant date and is adjusted to reflect the actual number of options that vest.

**(n) Income Taxes**

Income tax is comprised of current and deferred tax. Income tax is recognized in the statement of income, except to the extent that it relates to items recognized directly in equity, in which case the income tax is also recognized directly in equity.

Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantively enacted, at the end of the reporting period, and any adjustment to tax payable in respect of previous years.

In general, deferred tax is recognized in respect of temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the consolidated financial statements. Deferred income tax is determined on a non-discounted basis using tax rates and laws that have been enacted or substantively enacted at the interim condensed consolidated financial statements date and are expected to apply when the deferred tax asset or liability is settled. Deferred tax assets are recognized to the extent that it is probable that the assets can be recovered.

Deferred income tax assets and liabilities are presented as non-current.

**(o) Earnings Per Share and Reserved Ordinary Shares**

Basic net income (loss) per ordinary share ("EPS") is computed by dividing net income (loss) applicable to Ordinary Shares by the weighted-average number of Ordinary Shares outstanding for the period. Diluted EPS reflects the potential dilution that would occur if securities or other contracts to issue Ordinary Shares were exercised or converted into Ordinary Shares. For the three and nine months ended September 30, 2012 and for the nine months ended September 30, 2011, all potentially dilutive securities have an anti-dilutive effect on EPS and accordingly, basic and diluted weighted average shares are the same. For the three months ended September 30, 2011, 31,234,810 Ordinary Shares (from the effective conversion of the Series C Preferred shares into Ordinary Shares) and warrants to purchase 23,605,287 Ordinary Shares with a conversion price or exercise prices, which are less than the average fair value of our Ordinary Shares of \$0.16, were included in the calculation of diluted shares. All other potentially dilutive securities have been excluded from the calculation as the effect would have been anti-dilutive.

As of September 30, 2012, a total of 102,248,900 shares of potentially dilutive securities have been excluded from the calculation of EPS, as the effect of including these securities would be anti-dilutive, as follows:

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**Potentially Dilutive Securities as of September 30, 2012**

	<b>Equivalent Ordinary Shares</b>
Series C Preferred .....	30,734,810
Warrants .....	57,337,090
Stock options .....	14,177,000
Total .....	102,248,900

Also as of September 30, 2012, the Company has reserved 102,248,900 Ordinary Shares for future issuance for the securities listed above.

**(p) Use of Accounting Judgments and Estimates**

The preparation of these consolidated interim financial statements requires management to make judgments, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets and liabilities, income and expenses. Actual amounts may differ from these estimates.

These consolidated interim financial statements include estimates which, by their nature, are uncertain. The impacts of such estimates are pervasive throughout the consolidated financial statements and may require accounting adjustments based on future occurrences. Revisions to accounting estimates are recognized in the period in which the estimate is revised and the revision affects both current and future periods.

Management has made significant assumptions about the future and other sources of estimation uncertainty at the statement of financial position date that could result in a material adjustment to the carrying amounts of assets and liabilities in the event that actual results differ.

The following sections provide details on the significant accounting judgments and estimates used by the Company to prepare these consolidated interim condensed financial statements.

**(1) Judgments**

The key judgments made in applying accounting policies that have the most significant effect on the amount recognized in these consolidated interim condensed financial statements are as follows:

*(i) Commitments and contingencies*

Management has applied judgment in determining whether various contingencies and commitments require disclosure in the financial statements and also the amount of the contingency and commitment.

**(2) Use of Estimates**

Information about assumptions and estimation uncertainties that have a significant risk of resulting in a material adjustment to these consolidated interim condensed financial statements are as follows:

*(i) Compound instruments*

The Company estimated the fair value of the liability component of the Series C Preferred, including the related warrants, by discounting the redemption amount at a market rate for a



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similar liability that does not have an associated equity component. Warrants were issued with the Series C Preferred and their fair value was estimated using the Black Scholes options pricing model. Further, as the Series C Preferred is convertible, a portion of the proceeds were allocated to the conversion feature embedded in the Series C Preferred. Also, see Note 7 (a).

(ii) *Warrants and Options*

The Company uses the Black-Scholes option pricing model to value warrants and stock options. The Black-Scholes model requires the use of a number of assumptions, including expected share price volatility, risk-free interest rates, and the expected term of the warrants and options. The company also in certain cases applied a discount to the quoted stock price in the Black-Scholes calculation. The expected term of stock options represents the period of time that the stock options granted are expected to be outstanding. The estimated forfeiture rate is based upon a combination of industry data and the Company's historical experience. The estimated expected share price volatility is based on the combination of the Company's historical share price volatility and the expected volatility of a similar entity with publicly-traded securities. The risk-free interest rate is based on the U.S. Treasury bill rate for the expected term of the related warrants and stock options. As the Company does not pay dividends, the dividend rate variable in the Black-Scholes model is zero

(iii) *Accounts receivable*

Accounts receivable are recorded at the estimated recoverable amount which requires management to estimate uncollectable accounts.

(iv) *Property and equipment*

Management estimates the useful lives of property and equipment based on the period during which the assets are expected to be available for use. The amounts and timing of recorded expenses for depreciation or amortization of property and equipment for any period are affected by these estimated useful lives. The estimates are reviewed at least annually and are updated if expectations changes as a result of physical wear and tear, technical or commercial obsolescence, and legal or other limits to use. If is possible that changes in these factors may cause significant changes in the estimated useful lives of the Company's property and equipment in the future.

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**4. Property and Equipment**

The Company's property and equipment compromise computer hardware, computer software, furniture and equipment and leasehold improvements.

Property and equipment at September 30, 2012 and December 31, 2011 includes \$155,910, of assets under finance leases. Accumulated depreciation at September 30, 2012 and December 31, 2011 includes \$33,161 and \$9,106 respectively, of accumulated depreciation applicable to office equipment assets under finance leases.

Depreciation and amortization expense for the three months ended September 30, 2012 and 2011 was \$21,937 and \$68,381 respectively, and for the nine months ended September 30, 2012 and 2011 was \$68,835 and \$143,521, respectively.

The net book value of computer hardware, computer software, furniture and equipment and leasehold improvements can be analyzed as follows:

	Computer Hardware	Computer Software	Office Equipment	Furniture	Leasehold Improvements	Total
<b>Cost</b>						
<b>Balance at December 31, 2011</b>	\$ 112,227	\$ 739,664	\$ 100,248	\$ 48,254	\$101,735	\$1,102,128
Additions	\$ 5,726	-	-	-	-	\$ 5,726
Deletions	-	-	-	-	-	-
<b>Balance at September 30, 2012</b>	\$ 117,953	\$ 739,664	\$ 100,248	\$ 48,254	\$ 101,735	\$1,107,854
<b>Accumulated Depreciation and Amortization</b>						
<b>Balance at December 31, 2011</b>	\$ (105,452)	\$ (668,610)	\$ (25,920)	\$ (41,478)	\$ (22,010)	\$ (863,470)
Depreciation and amortization for the period	\$ (4,224)	\$ (27,941)	\$ (14,261)	\$ (1,242)	\$ (21,167)	\$ (68,835)
Deletions	-	-	-	-	-	-
<b>Balance at September 30, 2012</b>	\$ (109,676)	\$ (696,551)	\$ (42,720)	\$ (42,720)	\$ (43,177)	\$ (932,305)
<b>Net book value:</b>						
<b>At December 31, 2011</b>	\$ 6,775	\$ 71,054	\$ 74,328	\$ 6,776	\$ 79,725	\$ 238,658
<b>At September 30, 2012</b>	\$ 8,277	\$ 43,113	\$ 60,067	\$ 5,534	\$ 58,558	\$ 175,549

**5. Related Party Transactions**

From the Company's inception through March 11, 2011, Daryl Yurek was the Chief Executive Officer and Chairman of the Board of Directors of the Company. On March 11, 2011, Mr. Yurek resigned as CEO and as Chairman of the Board of the Company. Subsequent to that date, the Company no longer considers transactions with Mr. Yurek, or his affiliates, including Veracity Credit Consultants, LLC ("VCC"), to be related party transactions. While transactions with Mr. Yurek and his affiliates are no

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longer considered related party transactions subsequent to March 11, 2011, certain of these transactions continued subsequent to the date he resigned from the Company.

During the third quarter of 2011, the Company gave written notice to VCC that it was terminating its verbal office rent, equipment and supplies agreement effective September 21, 2011. Also, during the third quarter of 2011, the Company received notice from Mr. Yurek that he had ceased providing certain consulting services to the Company under a month to month verbal consulting agreement. As a result, effective August 31, 2011, the Company is no longer receiving or paying for these month to month consulting services.

Following are services provided by Mr. Yurek, or his affiliates including VCC, which were considered related party expense for the period January 1 to March 11, 2011.

**a) Marketing Expenses**

During 2011, the Company was provided facilities and call center services by VCC under a month to month service agreement. For the period January 1 through March 11, 2011, the Company incurred call center marketing expenses of \$10,800.

**(b) Office Rent, Equipment and Supplies**

During 2011, the Company shared office space with VCC and was allocated certain costs (based on head count) for office space rent, office equipment, supplies and other office related items. This sharing arrangement was a month to month cost sharing agreement with VCC. For the period January 1 through March 11, the Company incurred \$18,093 of expenses under this arrangement.

**(c) Consulting Fees to Daryl Yurek**

During 2011, the Company paid consulting fees to Daryl Yurek, or entities he controlled, under a month to month consulting agreement. For the period January 1 through March 11, 2011, the Company recognized \$30,277 of consulting fees under this arrangement.

**(d) Note Receivable**

In February 2010, the Company agreed to loan VCC \$67,220 with an advance of \$50,000 and a transfer of a previous prepayment for VCC to provide call center facilities and services as described above. The note receivable accrued interest at a rate of 10% per annum and was due on January 31, 2011. The note maturity was extended by one year in February 2011. At September 30, 2012, the note receivable balance, including accrued interest totaled \$46,907 and is reflected in the consolidated statement of financial position as a current asset. The note receivable and all accrued interest has been fully reserved as the Company believes it is unlikely the note receivable and accrued interest will be collected. The Company recognized interest income of \$0 and \$1,106 for three months ended September 30, 2012 and 2011, respectfully. For the nine months ended September 30, 2012 and 2011, the Company recognized interest income of \$1,151 and \$3,204, respectively.

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**6. Long-term Debt**

At September 30, 2012 and December 31, 2011, the Company's borrowings net of unamortized discounts consisted of the following:

	<u>September 30, 2012</u>	<u>December 31, 2011</u>
Current borrowings:		
Current portion of finance lease obligations .....	\$ 14,014	\$ 15,600
Total current borrowings .....	<u>\$ 14,014</u>	<u>\$ 15,600</u>
Long-term borrowings:		
Finance lease obligations, net of current portion .....	\$ 48,127	\$ 58,449
Total long-term borrowings .....	<u>\$ 48,127</u>	<u>\$ 58,449</u>

In May 2011, the Company entered into a finance lease for a printer/ copier machine. The lease has a two year term and a bargain purchase option at the end of the lease. The monthly lease payments are \$283.

In July 2011, the Company entered into a five year agreement to lease telecommunications equipment. The monthly lease payments are \$1,556 and the agreement includes a bargain purchase option at the end of the lease term.

The Company's minimum lease payments under its financing leases are as follows:

	<u>September 30, 2012</u>		<u>December 31, 2011</u>	
	<u>Present Value</u>	<u>Future Value</u>	<u>Present Value</u>	<u>Future Value</u>
Within one year .....	\$ 14,014	\$ 19,406	\$ 15,600	\$ 24,029
The second through fifth years .....	48,127	59,804	58,449	73,592
Total	<u>\$ 62,141</u>	<u>\$ 79,210</u>	<u>\$ 74,049</u>	<u>\$ 97,621</u>

The carrying amount of the office and telecommunication equipment under financing leases as of September 30, 2012 was \$62,141.

**7. Series C Mandatorily Redeemable Convertible Preferred Stock and Warrants**

**(a) Series C Preferred**

On February 24, 2011, the Company issued 3,123,481 shares of its Series C Preferred and five-year warrants to purchase 15,617,405 ordinary shares of the Company at an exercise price of \$0.12 per share, and received \$3,123,481 in gross proceeds. The holders of the Series C Preferred have the right to convert each share of their Series C Preferred into 10,000 Ordinary Shares of the Company, or 31,234,810 Ordinary Shares. At September 30, 2012 the Company has reserved 31,234,810 of its Ordinary Shares to effect the conversion of Series C Preferred.

The Series C Preferred is considered to be mandatory redeemable and is classified as a liability in the Company's consolidated statement of financial position. The Series C Preferred matures on February 24, 2016. Also below, see (d) Mandatory Conversion and (e) Maturity and Mandatory Redemption.

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In accordance with IAS 32, the Company estimated the fair value of the liability component of the Series C Preferred to be \$2,978,009, including the related warrants, by discounting the redemption amount at a market rate for a similar liability that does not have an associated equity component. The warrants were issued with the Series C Preferred and their fair value, using the Black Scholes options pricing model, is estimated to be \$814,105, resulting in a fair value of \$2,165,904 for the liability portion of the Series C Preferred. Further, as the Series C Preferred is convertible, a portion of the proceeds were allocated to the conversion feature embedded in the Series C Preferred. The residual amount reflecting the conversion feature of \$145,472 was recorded as the equity component.

The assumptions used in the Black-Scholes model are as follows: (1) dividend yield of 0%; (2) expected volatility of 115%, (3) weighted average risk-free interest rate of 2.19%, (4) expected life of 5.0 years, and (5) fair value of the Company's Ordinary Shares of \$0.13 per share. The amounts attributable to the warrants and the equity conversion feature aggregating \$957,577 have been recorded as a discount and deducted from the face value of the preferred stock in the accompanying interim condensed consolidated statement of financial position. The Series C Preferred and the related warrants are classified as liabilities, and the discount for the warrants and equity conversion feature, will be amortized over the period from issuance to February 2016 (the redemption date) at a charge to interest expense.

Effective on June 1 2012, holders of 50 Series C Preferred shares elected to convert their Series C Preferred shares into 500,000 Ordinary Shares. As a result, the Series C Preferred shares outstanding as of September 30, 2012 was 3,073.481.

The Series C Preferred shares earn dividends at 8% per annum. Accrued dividends on the Series C Preferred at September 30, 2012 were \$393,405. Assuming that none of the Series C Preferred outstanding as of September 30, 2012 are converted and all held until the Mandatory Redemption Date, the Company expects to accrue dividends on Series C Preferred in the amounts of \$243,154, \$245,878, \$245,878, \$245,878 and \$37,051 for the years ending December 31, 2012, 2013, 2014, 2015 and 2016, respectively.

On January 27, 2011, the Company authorized the Series C Preferred no par value shares and included the preferences, limitations and rights described below. At the same time, 3,000 authorized but unissued share in the Company were, by resolution of the Board of Directors of the Company, allotted for issuance as shares of Series C Preferred. Upon closing of the Recapitalization on February 24, 2011, the Company issued 3,123.481 shares of Series C Preferred. While the number of shares of Series C Preferred issued exceeded the number of shares initially authorized by the Board of Directors, it is allowable under the laws of the Cayman Islands to ratify and confirm the issuance of the additional 123,481 shares of Series C Preferred so long as the total authorized share capital of the Company has not been exceeded. In June 2011, the Board of Directors of the Company approved a resolution to ratify and confirm the issuance of the additional 123.481 shares of Series C Preferred from 3,000 to 3,123.481.

**(b) Dividends**

Dividends on Series C Preferred shares accrue at 8% per annum on the sum of the issue price of \$1,000 per share. Such dividends shall accrue whether or not declared by the Company's Board of Directors, and whether or not there are profits, surplus or other funds of the Company legally available for the payment of dividends, but no dividend shall be paid unless there are profits, surplus or other funds of the Company legally available for the payment of dividends and then only if declared by the Company' Board of Directors. Series C Preferred dividends have priority over dividends of the Company's ordinary shares. Series C Preferred are participating in any ordinary share dividends payable in shares and will be paid on the same terms and in the same fashion as if all of the Series C Preferred was converted into ordinary shares of the Company.

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**(c) Voting Rights**

Series C Preferred has voting rights and powers equal to the voting rights of ordinary shares on an “as if” converted basis. As long as one-third of the Series C Preferred is outstanding, the Company must obtain a waiver from the holders of the majority of the outstanding Series C Preferred before: a) declaring or paying cash dividends on ordinary shares b) authorizing or issuing additional shares of Series C Preferred, c) amending the rights, preferences or privileges of the Series C Preferred, d) authorizing any equity security senior to or on parity with the Series C Preferred, e) merging or consolidating with any other company, or selling all or substantially all of the Company’s assets, or f) effecting any transaction in which the holders of the Company’s voting interest prior to such transaction hold less than 50% of the voting interest in the Company following such transaction.

**(d) Mandatory Conversion**

Holders of the Series C Preferred may convert all or a portion of their holdings at any time into ordinary shares at a conversion price of \$0.10 per ordinary share, which may be adjusted from time to time for splits, reclassifications, dividends payable in shares and certain other events as set out in the Articles of Association of the Company in the form adopted on June 25, 2008 (the “Amended Articles”). Conversion rates are subject to certain anti-dilution adjustments as provided in the Amended Articles. The holders of the Series C Preferred are obligated to convert (“Mandatory Conversion”) their shares into ordinary shares at the applicable conversion price on the date on which one of the following occur (“Mandatory Conversion Date”):

- (1) The listing of the ordinary shares of the Company on a major U. S. Trading exchange (including the OTC Bulletin Board) and
  - The ordinary shares have a closing price of at least 200% of the conversion price for 20 consecutive trading days prior to the Mandatory Conversion Date;
  - The ordinary shares have an average trading volume of at least 500,000 shares for the 20 consecutive trading days prior to the Mandatory Conversion Date, and
  - The ordinary shares underlying conversion of the Series C Preferred have been registered under the Securities Act of 1933 for resale pursuant to an effective resale registration statement, or
- (2) The Company shall undertake an underwritten U. S. offering for an amount of at least \$15 million inclusive of any secondary offering of shares that might be included in such qualifying public offering.

**(e) Maturity and Mandatory Redemption**

The Series C Preferred has a maturity date of February 24, 2016. Any Series C Preferred outstanding on February 24, 2016 shall be subject to Mandatory Redemption at a price equal to the then Liquidation Preference Amount (as defined below), which the Company shall pay either in cash from available legal surplus or, in the absence thereof, by delivery of a senior note with an interest rate of 15% per annum and a 90 day maturity date.

**(f) Liquidation Preferences**

If prior to Mandatory Conversion, there is a liquidation, dissolution or winding up of the Company, either voluntary or involuntary, resulting in a distribution by the Company of its assets to the holders of any class or series of the Company’s Ordinary Shares or preferred shares ( a “Liquidation Event”), then , subject to applicable Cayman Islands law, before holders of the Ordinary Shares shall receive any consideration from such Liquidation Event, the holder of any then outstanding Series C Preferred shall be entitled to receive the greater of (i) 120% times the sum of (a) original issue price of \$1,000 per share plus (b) any accrued and unpaid dividends (the “Liquidation Preference Amount”) or (ii) that

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amount which is equal to what such holders would otherwise receive were they to convert their Series C Preferred at the then applicable conversion price.

**(g) Registration Rights**

The Company stated in the offering memorandum used in connection with the Recapitalization its intention to file with the Securities and Exchange Commission of the United States (the "SEC"), on or before 120 days from February 24, 2011, a registration statement under the Securities Act of 1933, as amended covering the resale of the Vendor Ordinary Shares as well as all ordinary shares of the Company reserved for issuance upon conversion of the Series C Preferred or exercise of the various warrants issued pursuant to the Recapitalization (collectively the "Registerable Shares"). The Company has investigated the registration of the Registerable shares and has determined not to pursue such registration.

**(h) Other Covenants**

The term of the Series C Preferred also limit ID Watchdog, Inc's ability to incur additional borrowings and to issue new preferred shares and make cash distributions. ID Watchdog Inc. may not:

- Incur additional debt that will cause the Company to have interest coverage of less than 2 times trailing EBITDA (Earnings before interest, taxes, depreciation and amortization expense) and then only if such indebtedness is junior in ranking to the Series C Preferred;
- Issue any new preferred stock that, in liquidation, ranks senior or pari passu with the Series C Preferred; and
- Make any distributions in cash or in kind to the holders of its Ordinary Shares.

**8. Interest Expense**

Interest expense for the three and nine months ended September 30, 2012 and 2011, includes the following:

	<b>For the Three Months Ended</b>	
	<b>September 30,</b>	
	<b>2012</b>	<b>2011</b>
Accrued dividends on Series C Preferred .....	\$ 61,975	\$ 62,983
Amortization of Series C Preferred liquidation preference .....	43,365	42,452
Amortization of fair value of Series C Preferred detachable warrants .....	47,474	47,835
Amortization of offering costs .....	28,963	29,349
Interest expense on finance leases and debt .....	3,125	294
Total Interest Expense	\$ 184,902	\$ 182,913

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	<b>For the Nine Months Ended</b>	
	<b>September 30,</b>	
	<b>2012</b>	<b>2011</b>
Accrued dividends on Series C Preferred .....	\$ 186,243	\$ 149,242
Amortization of Series C Preferred liquidation preference .....	130,237	106,130
Amortization of fair value of Series C Preferred detachable warrants .....	142,576	113,947
Amortization of offering costs .....	86,985	69,276
Interest expense on finance leases and debt .....	10,080	69,818
Total Interest Expense	\$ 556,121	\$ 508,413

### 9. Stock Options

On September 18, 2008, the Company adopted the ID Watchdog Stock Option Plan (the "Plan") authorizing a pool of up to 7.2 million stock options available for grant to employees and consultants of the Company. On January 8, 2010, shareholders of the Company voted to amend the Plan to authorize up to 12 million stock options available for grant, authorize a cashless exercise provision and other provisions to the Plan. The exercise prices of the options granted are determined by the Nominating Corporate Governance and Compensation Committee, which members are appointed by the Board of Directors, and are generally established at or above the closing price of the Company's ordinary shares on the TSXV on the date of grant. Options granted may have a term of up to ten years but will generally expire in five to seven years from the grant date and vest in accordance with the terms of the specific option agreement. The Plan replaced the Identity Rehab Corporation Stock Option Plan and all outstanding stock options to purchase ID Rehab's common stock were exchanged for stock options with the same terms to purchase the Company's ordinary shares effective September 18, 2008. All share-based employee compensation will be settled in newly issued shares.

Employee options generally vest over 18 to 36 months as long as the optionee remains in the Company's employ. Options granted to members of the Board of Directors generally vest immediately and options granted to consultants generally vest over a period of one to 60 months. Each tranche in an award is considered a separate award with its own vesting period and grant date fair value. Stock-based compensation costs are expensed over the vesting period with a corresponding increase in contributed surplus. When stock options are exercised, the cash proceeds along with the amount previously recorded as contributed surplus are recorded as share capital. A forfeiture rate is estimated on the grant date and is adjusted to reflect the actual number of options that vest.

The Company uses the Black-Scholes option pricing model to value stock options. The Black-Scholes model requires the use of a number of assumptions, including expected share price volatility, risk-free interest rates, and the expected term of the options. The expected term of stock options represents the period of time that the stock options granted are expected to be outstanding. The estimated expected share price volatility is based on the combination of the Company's historical share price volatility and the expected volatility of a similar entity with publicly-traded securities. The risk-free interest rate is based on the U.S. Treasury bill rate for the expected term of the related stock options. As the Company does not pay dividends, the dividend rate variable in the Black-Scholes model is zero. The following table summarizes the assumptions used to value stock options granted during the nine months ended September 30, 2012 and 2011:



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	<b>Nine Months Ended September 30,</b>	
	<b>2012</b>	<b>2011</b>
Weighted average share price.....	\$0.05	\$0.27
Expected term .....	2.5-5.0 years	2.5-3.3 years
Estimated volatility .....	110%	113%
Risk-free interest rate .....	.27%-.43%	1.76%
Dividend yield .....	0%	0%
Estimated forfeiture rate.....	5%	5%

The total fair value of options granted under the Plan for the nine months ended September 30, 2012 and 2011, was \$106,165 and \$1,491,850, respectively. The per option weighted average grant date fair value of options granted during the nine months ended September 30, 2012 and 2011, was \$0.013 and \$0.187, respectively.

**Stock Options Denominated in U.S. Dollars**

	<b>Nine Months Ended September 30,</b>			
	<b>2012</b>		<b>2011</b>	
	<b>Number of Shares</b>	<b>Weighted Average Exercise Price</b>	<b>Number of Shares</b>	<b>Weighted Average Exercise Price</b>
Outstanding, beginning of period .....	9,690,000	\$ 0.32	3,485,417	\$ 0.44
Granted .....	8,687,000	0.18	8,110,000	0.27
Cancelled .....	(5,000,000)	0.27	—	—
Expired/ Forfeited .....	(100,000)	0.28	(960,417)	0.18
Exercised .....	—	—	—	—
Outstanding, end of period .....	<u>13,277,000</u>	<u>\$ 0.25</u>	<u>10,635,000</u>	<u>\$ 0.33</u>
Exercisable, end of period .....	<u>7,123,473</u>	<u>\$ 0.29</u>	<u>4,317,360</u>	<u>\$ 0.32</u>

On June 14, 2011, the Company granted to directors, officers, employees and consultants of the Company stock options (“Options”) to acquire an aggregate of 8,110,000 ordinary shares under the plan. In addition, the Company granted, subject to requisite regulatory and shareholder approval, a further 3,772,000 ordinary shares under the Plan to directors and officers of the Company at an exercise price of US\$0.27 per Ordinary Share and expiring five years from the date of grant, subject to the terms and conditions of the Plan. Such further Options were subject to the condition that the Options may not be exercised prior to an amendment to the Plan to increase the maximum number of ordinary shares issuable under the Plan, as well as the grant of such further 3,772,000 Options receiving the requisite shareholder approval at the Company’s next shareholders’ meeting.

On February 23, 2012, the Company held a shareholders’ meeting whereupon the shareholders approved the following amendments to the Company’s Plan:

- (1) An increase in the number of Ordinary Shares which may be reserved for issuance pursuant to the exercise of options from 12,000,000 to 20,000,000, and
- (2) An increase in the number of Ordinary Shares that may be reserved for issuance pursuant to options granted to Insiders (as defined in TSVX Policy 1.0) from 10% to 15% of issued Ordinary Shares. Under TSXV policy, the latter proposal required “disinterested shareholder approval,” whereby shares held by the Company’s existing Insiders and their Associates (as defined in TSXV Policy 1.1) are excluded from voting.

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As a result of these amendments, the grants of the 3,772,000 options described above may be exercised in accordance with the vesting and other terms of the individual option grants beginning on February 23, 2012.

On September 17 and September 24, 2012, the Company granted to officers and employees of the Company Options to acquire an aggregate of 2,915,000 Ordinary Shares and granted to Directors of the Company Options to acquire an aggregate of 1,200,000 Ordinary Shares under the Plan, respectively. Such Options are exercisable at a price of U.S. \$0.12 per ordinary share, expire seven years from the date of grant and are subject to the terms and conditions of the Plan.

Also, on September 24, 2012, the Company granted to a consultant of the Company Options to acquire an aggregate of 500,000 Ordinary shares under the Plan. Such Options are exercisable at a price of U.S. \$0.12 per ordinary share, expire seven years from the date of grant and are subject to the terms and conditions of the Plan.

On September 21 and September 28, 2012, the Company and certain of its officers and Directors agreed to cancel a total of 4,500,000 Options that were exercisable at a price of U.S. \$0.27 per ordinary share.

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**Stock Options Denominated in Canadian Dollars**

	Nine Months Ended September 30,			
	2012		2011	
	Number of Shares	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price
Outstanding, beginning of period .....	900,000	\$ 0.60	985,000	\$ 0.60
Granted .....	—	—	—	—
Forfeited .....	—	—	—	—
Outstanding, end of period .....	<u>900,000</u>	<u>\$ 0.60</u>	<u>985,000</u>	<u>\$ 0.60</u>
Exercisable, end of period .....	<u>900,000</u>	<u>\$ 0.60</u>	<u>938,334</u>	<u>\$ 0.60</u>

A summary of stock options outstanding and stock options exercisable at September 30, 2012 follows:

**Stock Options Denominated in U.S. Dollars**

Exercise Prices	Stock Options Outstanding		Stock Options Exercisable
	Number of Shares	Weighted Average Remaining Contractual Term (In years)	Number of Shares
\$0.10-\$0.15 .....	4,915,000	6.81	2,000,000
\$0.16-\$0.25 .....	-	-	-
\$0.26-\$0.40 .....	6,747,000	3.70	3,511,251
\$0.41-\$0.60 .....	1,615,000	1.13	1,612,222
	<u>13,277,000</u>	<u>4.54</u>	<u>7,123,473</u>

**Stock Options Denominated in Canadian Dollars**

Exercise Prices	Stock Options Outstanding		Stock Options Exercisable
	Number of Shares	Weighted Average Remaining Contractual Term (In years)	Number of Shares
\$0.60 .....	900,000	1.18	900,000

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**10. Share-based compensation expense**

A summary of share-based compensation expense follows:

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2012</b>	<b>2011</b>	<b>2012</b>	<b>2011</b>
Share-based compensation expense – employees and directors .....	\$ 103,452	\$ 242,647	\$ 445,623	\$ 590,170
Share-based compensation expense – consultants .....	273	—	273	22,275
Total share-based compensation expense .....	<u>\$ 103,725</u>	<u>\$ 242,647</u>	<u>\$ 445,896</u>	<u>\$ 612,445</u>

**11. Warrants**

A summary of warrant activity for the Nine months ended September 30, 2012 and 2011 as follows.

The weighted average fair value of the warrants issued for the nine months ended September 30, 2012 and 2011 is .018 and .052, respectively. The following are the assumptions used to value the warrants granted during the six months ended September 30, 2012 and 2011:

	<b>September 30,</b>	
	<b>2012</b>	<b>2011</b>
Stock Price, in U. S dollars. ....	\$ 0.06	\$ 0.13
Expected term .....	5.0 years	5.0 years
Estimated volatility .....	113%	115%
Risk free interest rate	0.79%	2.21%
Dividend yield .....	0%	0%

The following tables present the composition of warrants outstanding as of September 30, 2012:

<b>Warrants Denominated in U.S. Dollars</b>		
<b>Exercise Prices</b>	<b>Shares</b>	<b>Weighted Average Remaining Contractual Term (years)</b>
\$0.10-\$0.15 .....	33,652,469	3.29
\$0.16-\$0.20 .....	—	—
\$0.21-\$0.30 .....	23,197,773	3.03
\$0.31-\$0.48 .....	486,848	0.93
Outstanding as of September 30, 2012 .....	<u>57,337,090</u>	<u>3.16</u>

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**Warrants Denominated in U.S. Dollars**

	Nine Months Ended September 30,			
	2012		2011	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding, beginning of period .....	72,268,292	\$ 0.22	31,147,441	\$ 0.37
Issued .....	320,000	0.20	19,965,886	0.12
Increase from anti-dilution adjustment.....	—	—	2,934,450	0.26
Exercised .....	—	—	—	—
Expired.....	(15,251,202)	0.38	—	—
Outstanding, end of period .....	<u>57,337,090</u>	<u>\$ 0.18</u>	<u>54,047,777</u>	<u>\$ 0.23</u>

Certain of the Company's warrant agreements contain anti-dilution provisions that will cause the exercise price of the warrant to decrease in the event that Company issues equity securities at a price lower than the existing warrant exercise price. As of September 30, 2012, 19,965,886 and 3,639,401 warrants with exercise prices of \$.12 per Ordinary Share and \$.10 per Ordinary Share, respectively, included such anti-dilution provisions. Because of the nature of these anti-dilution provisions, the Company is required to reflect these warrants in the consolidated statement of financial position as liabilities at their fair value. At September 30, 2012, the warrant liability totaled \$240,444.

**12. Issuance of Ordinary Shares and Warrants in Payment of Trade Payables**

On January 16, 2012, the Company satisfied \$38,400 of vendor trade payables by issuing to the vendor 320,000 of its Ordinary Shares, a warrant that entitles the holder to purchase 160,000 Ordinary Shares at a price of U.S. \$0.15 and a second Warrant that entitles the holder to purchase an additional 160,000 Ordinary Shares at a price of U.S. \$0.25. Both the first and the second Warrant will expire on January 16, 2017.

**13. Commitments and Contingencies**

On March 1, 2011, the Company entered into a three year data services agreement, which rate terms are effective on July 1, 2011 and are a supplement to an existing data services agreement with the same provider (the "Data Agreements"). The agreement requires the Company to pay the greater of actual data fees incurred or \$50,000 per month.

On November 19, 2012, the Company entered into a new two year agreement with this data provider which becomes effective on January 1, 2013, requires the Company to pay a monthly fee based on the greater of actual data usage priced at contractual rates or \$10,000 per month and terminates the Data Agreements effective December 31, 2012.

In July 2011, the Company entered into an agreement to lease office space in Denver, Colorado. The lease has a three year term with an option to extend the lease for an additional two years. The Company's minimum lease payments due for 2012, 2013 and 2014 are \$75,000 and \$75,000 and \$62,500, respectively. The minimum lease payments are subject to change based on contracted payment adjustments to accommodate additional employees in the office space. In addition, the Company will pay to the lessor \$2,425 per month for leasehold improvements paid for by the lessor. These payments for 2012, 2013 and 2014 are \$33,950, \$29,100 and \$24,250 respectively.

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**14. Reclassification of Financial Statement Amounts**

Certain prior year financial statement amount and categories have been reclassified to conform to the current year presentation.