

**ID WATCHDOG, INC.**  
**MANAGEMENT'S DISCUSSION AND ANALYSIS**  
**June 30, 2010**  
**(Expressed in U.S. Dollars)**

The following management's discussion and analysis ("MD&A") of the consolidated operating results and financial condition of ID Watchdog, Inc. for the three and six months ended June 30, 2010 and 2009 has been prepared based on information available to us as of August 20, 2010 and is intended to be read in conjunction with our consolidated interim financial statements and related notes for the three and six months ended June 30, 2010 and 2009 and in conjunction with our audited financial statements for the year ended December 31, 2009 and related MD&A. This MD&A contains "forward-looking information" and reference to the cautionary statement at the end of this MD&A is advised. Additional information relating to ID Watchdog, Inc. is available on SEDAR at [www.sedar.com](http://www.sedar.com).

We prepared our consolidated financial statements and related notes in accordance with accounting principles generally accepted in the United States of America ("U.S. GAAP") and, except where as noted, present our results in United States dollars.

For purposes of this discussion, we have used the foreign exchange rate in effect at June 30, 2010, of CDN\$1.00 = US\$0.9429.

**Overview and recent developments:**

Our business was founded in 2005 and our services provide detection and resolution solutions for identity theft and other consumer report problems. Our services monitor key data fields in consumer reports, access and analyze full reports, and resolve damage to consumer reports.

On September 5, 2008, we completed our initial public offering (our "IPO") raising \$8.1 million net of equity issuance costs. On September 17, 2008, the TSX Venture Exchange (the "TSXV") approved the listing of our ordinary shares and the classification of our company as a "Tier 1 Industrial or Technology Issuer." Our ordinary shares began trading on the TSXV on September 18, 2008, (the "Listing Date") under the symbol "IDW."

In November 2009, we completed a private placement for the sale of \$1,703,880 in Senior Extendible Deferred Convertible Notes with an interest rate of 10% (the "10% Notes"). After underwriting expenses, we received \$1.342 million. Interest is paid monthly from an escrow account funded with a deduction from the proceeds of the private placement to pay the interest to the 10% Note holders for the first year. The 10% Notes matured on April 19, 2010 and were extended, subject to certain provision, to September 30, 2010. During April 2010, the Company exercised the provision to extend the maturity of the 10% Notes until September 30, 2010 by paying the 2.5% extension fee and issuing 3,315,750 additional warrants per the terms of the agreement. The 10% Notes can be prepaid at any time at 110% of the principal amount if on or before the maturity date and at 120% thereafter. The 10% Notes may be convertible, at the option of the noteholder, at a price per share that is 30% below either (i) the offering price per share for shares of Ordinary Shares issued or reserved for issuance in an equity financing by the Company in the United States which is consummated after the October 21, 2009 and prior to September 30, 2010 or (ii) if clause (i) is not applicable, the average closing price of the Ordinary Shares on the TSX Venture Exchange for the 10 trading days preceding a conversion, but, so long as the Ordinary Shares are still trading on the TSX Venture Exchange, in no event shall the conversion price be less than U.S. \$0.2569 per share (the closing price of the Ordinary Shares on the TSX Exchange on October 21, 2009). Assuming the conversion price to be \$0.2569 per share, the 10% Notes may be convertible per \$1,000 in principal amount of the 10% Notes, into an aggregate of 6,632,453 Ordinary Shares. Purchasers of the 10% Notes received warrants to purchase 3,315,750 ordinary shares at an exercise price determined by formula equal to 110% of the issue price of a subsequent financing before September 30, 2010 of an amount greater than \$7.5 million or in the absence of a subsequent financing, the exercise price is \$0.2929 per share but, in no event less than the conversion price (\$0.2569 per share) of the Notes. In addition, if

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the 10% Notes are not repaid in full on or before the maturity date, then each purchaser shall receive warrants to purchase the same number of ordinary shares as previously received by the purchaser or an additional 3,315,750 warrants. The Company issued the additional 3,315,750 warrants to the noteholders on April 19, 2010 as part of the terms of the maturity extension. Agents for the Company received 617,529 warrants as part of their compensation with the same terms as the warrants issued to the noteholders. These convertible Notes and warrants have anti-dilution provisions that upon the subsequent sale or issuance of securities may cause a reduction of the outstanding convertible notes' conversion price and warrants' exercise price. The 10% Notes and warrants issued with the 10% Notes agreement has a registration rights agreement that call for at any time during the period beginning December 31, 2011, until December 30, 2014, holders have a one-time right by written notice of no less that 50.1% of the securities and underlying securities included in the 10% Note private placement to demand that the Company register all included and underlying securities. See Note 5 for additional information.

In March 2010, the Company completed a private placement for the sale of \$1,500,000 in convertible notes with an interest rate of 10% (the "2010 10% Notes"). After underwriting expenses, the Company received \$1,173,500 plus an additional amount of \$172,500 which was deposited into an escrow account to for interest payments. Interest is paid monthly from an escrow account funded by a deduction from the proceeds of the private placement to pay the interest to the 2010 10% Note holders for the first year. The 2010 10% Notes matured on August 10, 2010 and were extended, subject to certain provisions, to February 6, 2011. During August, the Company exercised the provision to extend the maturity of the 2010 10% Notes until February 6, 2011 by paying the 2.5% extension fee and issuing 2,055,000 additional warrants per the terms of the agreement. The 2010 10% Notes can be prepaid at any time at 110% of the principal amount if on or before the maturity date and at 120% thereafter. Purchasers of the 2010 10% Notes received warrants to purchase 2,055,000 ordinary shares at an exercise price determined by formula equal to 110% of the issue price of a subsequent financing before February 6, 2011 of an amount greater than \$7.5 million or in the absences of a subsequent financing, the exercise price is \$0.365 per share but, in no event less that the conversion price of the Notes. In addition, if the 2010 10% Notes are not repaid in full on or before the maturity date, then each purchaser shall receive warrants to purchase the same number of ordinary shares as previously received by the purchaser or an additional 2,055,000 warrants. Agents for the Company received 410,959 warrants as part of their compensation with the same terms as the warrants issued to the noteholders. These convertible notes and warrants have anti-dilution provisions that upon the subsequent sale or issuance of securities may cause a reduction of the outstanding convertible notes' conversion price and warrants' exercise price. The 2010 10% Notes and warrants issued with the 2010 10% Notes agreement has a registration rights agreement that call for at any time during the period beginning December 31, 2011, until December 30, 2014, holders have a one-time right by written notice of no less than 50.1% of the securities and underlying securities included in the 2010 10% Note private placement to demand that the Company register all included and underlying securities. See Note 5 for additional information.

On June 30, 2010, we had \$431,386 of cash and cash equivalents on hand. In addition, we had \$188,346 of restricted cash available to pay the interest payments on the 10% Notes and 2010 10% Notes.

In the first six months of 2010, we focused our marketing efforts on marketing affiliate relationships, employee benefit programs, outbound calling initiatives and Internet affiliates. At June 30, 2010, we had approximately 21,000 customers with active subscriptions. An active customer is defined as a customer who has paid monthly subscription fee and is no more than 60 days past due.

Our business plan for 2010 calls for maintaining our current level of customers while we structure the Company for a cash-flow neutral and then a positive cash flow position from operations and then returning to growing our customers base beginning in the third quarter of 2010. We were not able to

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maintain our level of customers during the first six months of 2010 and our customer base decreased to 21,000 at June 30, 2010 from 27,000 at December 31, 2009.

We are dependent upon our existing cash balances, along with our expected cash flow generated from gross profits to satisfy our marketing expenditures, general and administrative expenses, debt payments, and cash interest payments relating to our current operations and planned growth during the short term. Based on the Company's current operating plan, its existing working capital will not be sufficient to meet the cash requirements to fund the Company's operating expenses, required and potential payments under the 10% Notes, and the 2010 10% Notes, and working capital requirements through December 31, 2010 without additional sources of cash and/or the deferral, reduction or elimination of significant planned expenditures.

These factors raise substantial doubt about our ability to continue as a going concern. The Company intends to secure additional working capital through the sale of additional debt or equity securities. However, there is no assurance that the Company would be able to obtain such financing on favourable terms, if at all, or to successfully further reduce costs in such a way that would continue to allow the Company to operate its business. No arrangements or commitments for any such financing are in place at this time, and we cannot give any assurances about the availability or terms of any future financing.

**Development and marketing of services:**

We have developed a new product called idCHECK<sup>SM</sup>. idCHECK<sup>SM</sup> is a single-use identity theft product that allows consumers to instantly determine whether or not their personal information has ever been accessed by identity thieves. idCHECK is available as a standalone product or as a complement to our existing other three services. We believe our other three services and with the addition of idCHECK will benefit our customers by detecting and resolving identity theft and other consumer report data problems. Our services, ID Watchdog<sup>SM</sup>, ID SnapShot<sup>SM</sup> and ID Rehab<sup>SM</sup> are specifically designed to work together and are generally offered together through our ID Watchdog Plus<sup>SM</sup> plan for a monthly, annual or multi-year subscription fee. Our ID Watchdog<sup>SM</sup> service examines consumer databases to identify leading indicators of identity theft or manipulation. Customers are alerted upon the occurrence of events which signal that identify theft or personal identity data manipulation may be occurring. Our ID SnapShot<sup>SM</sup> service provides more detailed information about a consumer's identity data to pinpoint and scope suspected data manipulation. Once a customer's identity problem is identified, our ID Rehab<sup>SM</sup> identity theft resolution service is used to assist the customer in correcting and restoring records to the state before the data manipulation occurred.

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**Selected financial information:**

Our financial information set out below is based on and derived from our audited consolidated financial statements as of the dates and for the periods indicated and should be read in conjunction with our MD&A and the consolidated financial statements and the accompanying notes which are available on our website at [www.idwatchdog.com](http://www.idwatchdog.com) and/or the SEDAR website at [www.sedar.com](http://www.sedar.com). The following selected financial information has been prepared in accordance with U.S. GAAP. For reconciliation to Canadian generally accepted accounting principles see Note 8 to the consolidated financial statements.

	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>
	(unaudited)	(unaudited)	(unaudited)	(unaudited)
Revenue .....	\$ 888,815	\$ 1,929,860	\$ 2,078,418	\$ 3,143,881
Gross profit .....	798,439	1,467,377	1,843,663	2,417,494
Operating expense .....	(961,704)	(3,753,547)	(2,417,775)	(7,625,350)
Operating loss .....	(163,265)	(2,286,170)	(574,112)	(5,207,856)
Net loss applicable to ordinary shares .....	\$ (568,251)	\$ (1,686,342)	\$ (811,039)	\$ (5,669,015)
Basic and diluted net loss per share .....	\$ (0.01)	\$ (0.03)	\$ (0.01)	\$ (0.11)

	<b>June 30, 2010</b>	<b>December 31, 2009</b>
	(unaudited)	
<b>Balance Sheet Data:</b>		
Cash and cash equivalents (including restricted cash of \$188,346 and \$171,752 at June 30, 2010 and December 31, 2009, respectively) .....	\$ 619,732	\$ 660,441
Total assets .....	\$ 1,195,010	\$ 1,511,564
Total long-term liabilities .....	\$ 3,730	\$ 5,406
Total liabilities .....	\$ 5,178,316	\$ 4,711,632
Total shareholders' equity (deficit) .....	\$ (3,983,306)	\$ (3,200,068)

**Summary of quarterly results - unaudited:**

	<b>2010</b>	<b>2010</b>	<b>2009</b>	<b>2009</b>
	<b>Quarter 2</b>	<b>Quarter 1</b>	<b>Quarter 4</b>	<b>Quarter 3</b>
Revenue .....	\$ 888,815	\$ 1,189,602	\$ 1,340,975	\$ 1,422,746
Net loss .....	\$ (568,251)	\$ (242,788)	\$ (1,828,025)	\$ (1,271,082)
Net loss applicable to ordinary shares .	\$ (568,251)	\$ (242,788)	\$ (1,828,025)	\$ (1,271,082)
Basic and diluted net loss per share .....	\$ (0.01)	\$ nil	\$ (0.03)	\$ (0.02)
	<b>2009</b>	<b>2009</b>	<b>2008</b>	<b>2008</b>
	<b>Quarter 2</b>	<b>Quarter 1</b>	<b>Quarter 4</b>	<b>Quarter 3</b>
Revenue .....	\$ 1,929,860	\$ 1,214,021	\$ 1,409,959	\$ 1,282,631
Net loss .....	\$ (1,686,342)	\$ (3,982,673)	\$ (1,782,714)	\$ (1,866,300)
Net loss applicable to ordinary shares .	\$ (1,686,342)	\$ (3,982,673)	\$ (1,782,714)	\$ (3,364,704)
Basic and diluted net loss per share .....	\$ (0.03)	\$ (0.08)	\$ (0.04)	\$ (0.11)

Our revenue increased during each quarter in 2008 as a result of the ramp-up of our commercial operations. Our revenue declined during the first quarter of 2009 as compared to the fourth quarter of 2008 as a result of our efforts to improve customer retention rates and lower customer acquisition costs. During the second quarter of 2009, our revenues increased as we engaged several external call centers to sell and cross-sell our services in conjunction with their inbound and outbound calls. Our revenue

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declined in the third quarter of 2009 as compared to the second quarter of 2009 as a result of our efforts to reduce expenditures and conserve cash. Our revenues declined in the fourth quarter of 2009 as compared to the third quarter of 2009 as we continued to reduce expenditures, however, we were able to maintain our fourth quarter gross profit at approximately \$1,060 thousand. Our revenue decreased in the first quarter of 2010 as compared to the fourth quarter of 2009 as we continued to reduce expenditures, including marketing expenses, to conserve cash. However, we were able to maintain gross profit at \$1,045 thousand for the first quarter 2010. Revenue declined in the second quarter 2010 as compared to the first quarter 2010 as we continued to reduce expenditures, including marketing expenses, to conserve cash.

Our net losses increased significantly during the second quarter of 2008 mainly due to increased marketing expenses during this quarter. Our net loss decreased during the third quarter of 2008 as compared to the second quarter of 2008 as we reduced marketing expenditures during the third quarter of 2008 in order to conserve cash prior to the date of our IPO. Our net loss decreased during the fourth quarter of 2008 as compared to the third quarter of 2008 due to the net change in the following components which include an increase in our marketing expenditures and general and administrative expenses subsequent to receiving cash from our IPO, and then these increases were offset by the recognition of a \$757,722 non-cash gain on derivative contract liabilities.

Our net loss increased during the first quarter of 2009 as compared to the fourth quarter 2008 due to the non-cash gain of \$757,722 recognized in the fourth quarter 2008 related to the derivative contract liabilities mentioned above, and \$866,617 of non-cash loss recognized in the first quarter of 2009 due to the increase in the derivative contract liability as the fair market value of our ordinary shares increased during the quarter. The change in the value of the derivative contract liability caused an increase in the net loss of \$1,624,339 when comparing the first quarter of 2009 to the fourth quarter of 2008. In addition, the Company increased its marketing and general and administrative expenses during the first quarter of 2009 in accordance with its plan to grow revenues, customers and systems to support the operations.

Our net loss decreased during the second quarter 2009 as compared to the first quarter 2009 primarily due to the turnaround of the gain/loss on the derivative contract liability. The Company posted a non-cash loss of \$866,617 in the first quarter of 2009 and a gain of \$781,960 in the second quarter due to the change in the fair market value ("FMV") of our ordinary shares. The change in the FMV of our ordinary shares caused a decrease of \$1,648,577 in the net loss when comparing the 2009 second quarter to the first quarter. The increase in revenue during the second quarter and the resulting increase in gross profit primarily accounted for the remaining decrease in net loss.

Our net loss decreased during the third quarter of 2009 as compared to the second quarter 2009 primarily as a result of a \$1 million decrease in marketing expenses, a decrease in general and administrative expenses and a reduction in interest expense due to the conversion of the convertible debentures into the Company's ordinary shares during the second quarter of 2009. These third quarter decreases were offset by \$781,960 non-cash gain reported in the second quarter of 2009. Our net loss increased \$556,943 during the fourth quarter of 2009 as compared to the third quarter of 2009 mainly due to \$430,000 of additional interest expense incurred during the fourth quarter of 2009 which relates to the sale of \$1,703,880 in Senior Extendible Deferred Convertible Notes with an interest rate of 10% (the "10% Notes"). Fourth quarter interest expense includes \$137,457 of non-cash amortization of debt offering costs and \$250,204 of non-cash amortization of debt discounts. In addition, during the fourth quarter ending December 31, 2009, we recorded a \$238,700 loss on derivative contract liabilities related to warrants denominated in Canadian dollars, the issue of warrants and a beneficial conversion feature related to our 10% senior extendible deferred convertible notes issued in the fourth quarter of 2009. An

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improvement in operating loss by \$210,000 in the fourth quarter 2009 as compared to 2008 offset the additional expenses from above.

Our net loss decreased during the first quarter 2010 as compared to the fourth quarter 2009 as a result of our plan to reduce expenditures in order to conserve cash. Our marketing expenses and general and administrative expenses were reduced by \$475 thousand and \$281 thousand, respectively as compared to the fourth quarter of 2009. In addition, our net loss decreased during the first quarter 2010 as compared to the fourth quarter 2009, due to a turnaround of the gain/loss on derivative contract liability which accounts for a decrease in the net loss comparison by \$1,096 thousand. The Company posted a non-cash loss of \$239 thousand in the fourth quarter 2009 and a gain of \$857 thousand in the first quarter of 2010 primarily due to the change in FMV of our ordinary shares which accounts for the \$1,096 decrease in net loss. An increase in interest expense (non-cash amount of \$249 thousand) during the first quarter of 2010 offsets the net loss decrease from above and primarily accounts for the remaining change in net loss. Interest expense increased due to the issuance of the 2010 10% Notes in February and March 2010 and their related amortization of non-cash debt discount and debt offering costs charged to interest expense.

Our net loss increased during the second quarter 2010 as compared to the first quarter 2010 due to the non-operating and non-cash gain of \$59 thousand in the second quarter of 2010 as compared to \$857 thousand in the first quarter of 2010. The non-operating, non-cash gain is due to the change in the fair market value of our ordinary shares resulting from the derivative contract liability associated with the warrants and beneficial conversion feature related to the 10 % Notes and the 2010 10% Notes. Our operating loss decreased in the second quarter 2010 to a loss of \$163 thousand from a loss of \$410 thousand in the first quarter of 2010 reflecting the Company's planned reduction in expenditures in order to conserve cash.

Our net loss applicable to ordinary shares increased during the first three quarters of 2008 due to our increasing net losses discussed above and as a result of dividends on redeemable convertible preferred shares, deemed dividends on redeemable convertible preferred shares and accretion of the discount related to redeemable convertible preferred shares. We incurred a total of \$2,782,704 of non-cash expenses relating to our redeemable convertible preferred shares during the period January 28, 2008 through September 5, 2008, the date that our redeemable convertible preferred shares were converted into ordinary shares and warrants to purchase ordinary shares. Our net loss applicable to ordinary shares decreased during the fourth quarter of 2008 as compared to the third quarter of 2008 as we did not incur expenses related to redeemable convertible preferred shares during the fourth quarter of 2008. Our quarterly net loss applicable to ordinary shares does not differ from our net loss beginning with the fourth quarter 2008 and through the second quarter 2010.

**Results of operations:**

***Comparison of the three months ended June 30, 2010 to the three months ended June 30, 2009***

***Revenue and gross profit***

For the three months ended June 30, 2010 and 2009, we recognized revenue of \$888,815 and \$1,929,860, respectively, from the sale of our services. Our cost of revenue for the three months ended June 30, 2010, was \$90,376 resulting in a gross profit of \$798,439, while our cost of revenue for the three months ended June 30, 2009, was \$462,483 resulting in a gross profit of \$1,467,377. Our revenue and cost of revenue decreased during the second quarter of 2010 as compared to the second quarter of 2009, due to decreased marketing expenditures and smaller customer base during 2010 as compared to the 2009 period. Despite

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our efforts and plans to maintain our existing customer base, we continued to lose customers during the second quarter 2010 resulting in lower revenue in the second quarter.

***Marketing expense***

Our marketing expense includes marketing agents' commissions, advertising and production costs, website design and development costs and marketing and call center staff wages and related expenses. Our marketing expense for the three months ended June 30, 2010, was \$374,652 as compared to \$2,544,735 for the same period in 2009. This decrease reflects our plans to reduce expenses and conserve cash.

We have a month-to-month services agreement with Veracity Credit Consultants, LLC ("VCC"), an entity controlled by Madison Ayer, Vice President and Justin Yurek, ID Watchdog's former President and Vice President, to provide call center facilities and call center services at prevailing market rates. We incurred \$37,207 and \$36,624 of related party call center marketing expense relating to this arrangement during the three months ended June 30, 2010 and 2009, respectively.

***General and administrative expense***

General and administrative expense includes non-marketing salaries, non-marketing benefits, consultants' fees, rent, telephone, insurance, depreciation, other general and administrative expense and related party consulting expense.

Our general and administrative expense amounted to \$587,052 and \$1,208,812 during the three months ended June 30, 2010 and 2009, respectively. This \$621,760 decrease in general and administrative expense was due to our plans to reduce expenses and conserve cash.

During the three months ended June 30, 2010, we incurred related party consulting expense of \$51,700 as compared to \$105,675 during the same period in 2009, a decrease of \$53,975. During the three months ended June 30, 2010, we incurred \$41,596 of consulting expense for services from Daryl Yurek, our Chairman and CEO, as compared to \$50,263 during the same period in 2009. This decrease was a result of decreased compensation rates. Consulting services provided by our directors decreased to nil during the three months ended June 30, 2010 from \$37,909 during the same period in 2009 and consulting services provided by VCC and Bolder Venture Partners, LLC ("Bolder") an entity controlled by the Company's Chief Executive Officer, decreased to nil during the second quarter of 2010 from \$17,503 during the same period in 2009. These decreases reflect a reduction in services provided. During May 2010, the Company relocated its offices to the office building and area leased by VCC. The Company has a month-to-month lease agreement in which it pays VCC for its pro-rata share of the lease facility costs. For the three months ending June 30, 2010, the related party lease facility costs were \$10,104.

***Interest expense***

In June and July 2007, we issued \$3,725,291 of convertible debentures that bear interest at 9% per annum and matured in June and July 2009. All of the convertible debentures converted into the Company's ordinary shares prior to September 2009.

In November 2009, we completed a private placement for the sale of \$1,703,880 in Senior Extendible Deferred Convertible Notes that bear interest at 10% per annum and mature April 19, 2010 but were extended, subject to certain provisions, to September 30, 2010.

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In March 2010, we completed a private placement for the sale of \$1,500,000 in Extendible Deferred Convertible Notes that bear interest at 10% per annum and mature August 10, 2010 but were extended, subject to certain provisions, to February 6, 2011.

Interest expense during the three months ended June 30, 2010 and 2009 totalled \$465,719 and \$193,252, respectively. These amounts included non-cash amortization of debt offering costs of \$157,201 and \$78,387 in each period during 2010 and 2009, respectively. Interest expense also included non-cash amortization of debt discount of \$174,063 and \$41,759 during each of the periods in 2010 and 2009, respectively.

***Gain (Loss) on derivative contract liabilities***

We have recorded the fair value of our warrants denominated in Canadian dollars as a derivative contract liability in accordance with U.S. GAAP. Each period, we adjust the estimated fair value of these derivative financial instruments through a charge or credit to earnings until such time as the instruments are exercised, expire or are permitted to be classified in shareholders' equity. During the three months ended June 30, 2010, we incurred a non-cash gain of \$59,000 as compared to a non-cash gain of \$781,960 during the three months ended June 30, 2009 related to the change in fair value of our derivative contract liabilities. This decrease in the fair value of our derivative contract liabilities was mainly a result of a decrease in the market price of our ordinary shares from \$0.38 at December 31, 2009 to \$0.08 per share at June 30, 2010.

We have recorded the fair value of our warrants issued in the first quarter of 2010, the fourth quarter of 2009 and with our IPO in September 2008 as a derivative contract liability in accordance with U.S. GAAP. Each period, we adjust the estimated fair value of these derivative financial instruments through a charge or credit to earnings until such time as the instruments are exercised, expire or are permitted to be classified in shareholders' equity. The detachable warrants and placement agent warrants have been valued separately at fair value using the Black-Scholes methodology. As of March 2010 and October 2009, the fair value calculations assumed a risk-free interest rate of 2.35% and 2.3%, respectively, estimated expected volatility of 50% and 38%, respectively and no dividends. The value assigned to the detachable warrants and placement agent warrants during March 2010 and October 2009 is \$211,780 and \$310,530, respectively using the Black-Scholes option-pricing model and is included in derivative contract liabilities on the Company's consolidated balance sheets. The warrants are adjusted to reflect fair value, using the Black-Scholes option-pricing model, at each reporting period end, with any increase or decrease in the fair value being recorded in results of operations as an adjustment to fair value of derivatives. At June 30, 2010, the fair value of these derivative instruments is \$174,000 which resulted in a gain of \$25,000 for the three months ended June 30, 2010.

The 10% Notes were determined to have a beneficial conversion feature because the conversion price was less than the market value of the Company's ordinary shares at the time of issuance. The intrinsic value assigned to the beneficial conversion feature during October 2009 is \$323,790 and is included in derivative contract liabilities on the Company's consolidated balance sheets. The beneficial conversion feature is adjusted to reflect fair value, using the Black-Scholes option-pricing model, at each reporting period end, with any increase or decrease in the fair value being recorded in results of operations as an adjustment to fair value of derivatives. At June 30, 2010, the fair value of these derivative instruments is \$1,000 which resulted in a gain of \$34,000 for the three months ended June 30, 2010.

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*Comparison of the six months ended June 30, 2010 to the six months ended June 30, 2009*

***Revenue and gross profit***

For the six months ended June 30, 2010 and 2009, we recognized revenue of \$2,078,418 and \$3,143,881, respectively, from the sale of our services. Our cost of revenue for the six months ended June 30, 2010, was \$234,755 resulting in a gross profit of \$1,843,663, while our cost of revenue for the six months ended June 30, 2009, was \$726,387 resulting in a gross profit of \$2,417,494. Our revenue and cost of revenue decreased during the first six months of 2010 as compared to the first six months of 2009, due to decreased marketing expenditures and smaller customer base during 2010 as compared to the 2009 period. Despite our efforts and plans to maintain our existing customer base, we continued to lose customers during the first six months of 2010 resulting in lower revenue in this period.

***Marketing expense***

Our marketing expense includes marketing agents' commissions, advertising and production costs, website design and development costs and marketing and call center staff wages and related expenses. Our marketing expense for the six months ended June 30, 2010, was \$1,021,819 as compared to \$5,038,716 for the same period in 2009. This decrease reflects our plans to reduce expenses, conserve cash but, maintain our level of customers and hold gross margins steady.

We have a month-to-month services agreement with VCC to provide call center facilities and call center services at prevailing market rates. We incurred \$94,276 and \$84,300 of related party call center marketing expense relating to this arrangement during the six months ended June 30, 2010 and 2009, respectively.

***General and administrative expense***

General and administrative expense includes non-marketing salaries, non-marketing benefits, consultants' fees, rent, telephone, insurance, depreciation, other general and administrative expense and related party consulting expense.

Our general and administrative expense amounted to \$1,395,956 and \$2,586,634 during the six months ended June 30, 2010 and 2009, respectively. This \$1,190,678 decrease in general and administrative expense was due to our plans to reduce expenses and conserve cash.

During the six months ended June 30, 2010, we incurred related party consulting expense of \$106,546 as compared to \$188,455 during the same period in 2009, a decrease of \$81,909. During the six months ended June 30, 2010, we incurred \$96,442 of consulting expense for services from Daryl Yurek, our Chairman and CEO, as compared to \$100,050 during the same period in 2009. This decrease was a result of a decrease in compensation rates during the second quarter of 2010. Consulting services provided by our directors decreased to nil during the six months ended June 30, 2010 from \$55,909 during the same period in 2009 and consulting services provided by VCC and Bolder, decreased to nil during the first six months of 2010 from \$32,496 during the same period in 2009. These decreases reflect a reduction in services provided. During May 2010, the Company relocated its offices to the office building and area leased by VCC. The Company has a month-to-month lease agreement in which it pays VCC for its pro-rata share of the lease facility costs. For the six months ending June 30, 2010, the related party lease facility costs were \$10,104.

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***Interest expense***

In June and July 2007, we issued \$3,725,291 of convertible debentures that bear interest at 9% per annum and matured in June and July 2009. All of the convertible debentures converted into the Company's ordinary shares prior to September 2009.

In November 2009, we completed a private placement for the sale of \$1,703,880 in Senior Extendible Deferred Convertible Notes that bear interest at 10% per annum and mature April 19, 2010 but were extended, subject to certain provisions, to September 30, 2010.

In March 2010, we completed a private placement for the sale of \$1,500,000 in Extendible Deferred Convertible Notes that bear interest at 10% per annum and mature August 10, 2010 but were extended, subject to certain provisions, to February 6, 2011.

Interest expense during the six months ended June 30, 2010 and 2009 totalled \$1,156,722 and \$396,755, respectively. These amounts included non-cash amortization of debt offering costs of \$421,133 and \$160,072 in each period during 2010 and 2009, respectively. Interest expense also included non-cash amortization of debt discount of \$546,542 and \$84,215 during each of the periods in 2010 and 2009, respectively.

***Gain (Loss) on derivative contract liabilities***

We have recorded the fair value of our warrants denominated in Canadian dollars as a derivative contract liability in accordance with U.S. GAAP. Each period, we adjust the estimated fair value of these derivative financial instruments through a charge or credit to earnings until such time as the instruments are exercised, expire or are permitted to be classified in shareholders' equity. During the six months ended June 30, 2010, we incurred a non-cash gain of \$916,501 as compared to a non-cash charge of \$84,657 during the six months ended June 30, 2009 related to the change in fair value of our derivative contract liabilities. This decrease in the fair value of our derivative contract liabilities was mainly a result of a decrease in the market price of our ordinary shares from \$0.38 at December 31, 2009 to \$0.08 per share at June 30, 2010.

We have recorded the fair value of our warrants issued in the first quarter of 2010, the fourth quarter of 2009 and with our IPO in September 2008 as a derivative contract liability in accordance with U.S. GAAP. Each period, we adjust the estimated fair value of these derivative financial instruments through a charge or credit to earnings until such time as the instruments are exercised, expire or are permitted to be classified in shareholders' equity. The detachable warrants and placement agent warrants have been valued separately at fair value using the Black-Scholes methodology. As of March 2010 and October 2009, the fair value calculations assumed a risk-free interest rate of 2.35% and 2.3%, respectively, estimated expected volatility of 50% and 38%, respectively and no dividends. The value assigned to the detachable warrants and placement agent warrants during March 2010 and October 2009 is \$211,780 and \$310,530, respectively using the Black-Scholes option-pricing model and is included in derivative contract liabilities on the Company's consolidated balance sheets. The warrants are adjusted to reflect fair value, using the Black-Scholes option-pricing model, at each reporting period end, with any increase or decrease in the fair value being recorded in results of operations as an adjustment to fair value of derivatives. At June 30, 2010, the fair value of these derivative instruments is \$174,000 which resulted in a gain of \$602,501 for the six months ended June 30, 2010.

The 10% Notes were determined to have a beneficial conversion feature because the conversion price was less than the market value of the Company's ordinary shares at the time of issuance. The intrinsic value

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assigned to the beneficial conversion feature during October 2009 is \$323,790 and is included in derivative contract liabilities on the Company's consolidated balance sheets. The beneficial conversion feature is adjusted to reflect fair value, using the Black-Scholes option-pricing model, at each reporting period end, with any increase or decrease in the fair value being recorded in results of operations as an adjustment to fair value of derivatives. At June 30, 2010, the fair value of these derivative instruments is \$1,000 which resulted in a gain of \$314,000 for the six months ended June 30, 2010.

**Liquidity and capital resources:**

*Recent financings*

*Private Placement – 10% Senior Extendible Deferred Convertible Notes*

In November 2009, we completed a private placement for the sale of \$1,703,880 in Senior Extendible Deferred Convertible Notes with an interest rate of 10% (the "10% Notes"). After underwriting expenses, we received \$1.342 million. Interest is paid monthly from an escrow account funded with a deduction from the proceeds of the private placement to pay the interest to the 10% Note holders for the first year. The 10% Notes mature on April 19, 2010 and were extended, subject to certain provision, to September 30, 2010. During April 2010, the Company exercised the provision to extend the maturity of the 10% Notes until September 30, 2010 by paying the 2.5% extension fee and issuing 3,315,750 additional warrants per the terms of the agreement. The 10% Notes can be prepaid at any time at 110% of the principal amount if on or before the maturity date and at 120% thereafter. The 10% Notes may be convertible, at the option of the noteholder, at a price per share that is 30% below either (i) the offering price per share for shares of Ordinary Shares issued or reserved for issuance in an equity financing by the Company in the United States which is consummated after the October 21, 2009 and prior to September 30, 2010 or (ii) if clause (i) is not applicable, the average closing price of the Ordinary Shares on the TSX Venture Exchange for the 10 trading days preceding a conversion, but, so long as the Ordinary Shares are still trading on the TSX Venture Exchange, in no event shall the conversion price be less than U.S. \$0.2569 per share (the closing price of the Ordinary Shares on the TSX Exchange on October 21, 2009). Assuming the conversion price to be \$0.2569 per share, the 10% Notes may be convertible per \$1,000 in principal amount of the 10% Notes, into an aggregate of 6,632,453 Ordinary Shares. Purchasers of the 10% Notes received warrants to purchase 3,315,750 ordinary shares at an exercise price determined by formula equal to 110% of the issue price of a subsequent financing before September 30, 2010 of an amount greater than \$7.5 million or in the absence of a subsequent financing, the exercise price is \$0.2929 per share but, in no event less than the conversion price (\$0.2569 per share) of the Notes. In addition, if the 10% Notes are not repaid in full on or before the maturity date, then each purchaser shall receive warrants to purchase the same number of ordinary shares as previously received by the purchaser or an additional 3,315,750 warrants. The Company issued the additional 3,315,750 warrants to the noteholders on April 19, 2010 as part of the terms of the maturity extension. Agents for the Company received 617,529 warrants as part of their compensation with the same terms as the warrants issued to the noteholders. These convertible Notes and warrants have anti-dilution provisions that upon the subsequent sale or issuance of securities may cause a reduction of the outstanding convertible notes' conversion price and warrants' exercise price. The 10% Notes and warrants issued with the 10% Notes agreement has a registration rights agreement that call for at any time during the period beginning December 31, 2011, until December 30, 2014, holders have a one-time right by written notice of no less than 50.1% of the securities and underlying securities included in the 10% Note private placement to demand that the Company register all included and underlying securities. See Note 5 in the consolidated financial statements for additional information.

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***Private Placement – 10% Extendible Convertible Notes***

In March 2010, the Company completed a private placement for the sale of \$1,500,000 in convertible notes with an interest rate of 10% (the "2010 10% Notes"). After underwriting expenses, the Company received \$1,173,500 plus an additional amount of \$172,500 which was deposited into an escrow account to for interest payments. Interest is paid monthly from an escrow account funded by a deduction from the proceeds of the private placement to pay the interest to the 2010 10% Note holders for the first year. The 2010 10% Notes matured on August 10, 2010 and were extended, subject to certain provisions, to February 6, 2011. As part of the terms related to extending the maturity date, the Company paid the noteholders a 2.5% extension fee (\$37,500) of the principal amount outstanding and issued 2,055,000 warrants. The 2010 10% Notes can be prepaid at any time at 110% of the principal amount if on or before the maturity date and at 120% thereafter. Purchasers of the 2010 10% Notes received warrants to purchase 2,055,000 ordinary shares at an exercise price determined by formula equal to 110% of the issue price of a subsequent financing before February 6, 2011 of an amount greater than \$7.5 million or in the absences of a subsequent financing, the exercise price is \$0.365 per share but, in no event less that the conversion price of the Notes. In addition, if the 2010 10% Notes are not repaid in full on or before the maturity date, then each purchaser shall receive warrants to purchase the same number of ordinary shares as previously received by the purchaser or an additional 2,055,000 warrants. Agents for the Company received 410,959 warrants as part of their compensation with the same terms as the warrants issued to the noteholders. These convertible notes and warrants have anti-dilution provisions that upon the subsequent sale or issuance of securities may cause a reduction of the outstanding convertible notes' conversion price and warrants' exercise price. The 2010 10% Notes and warrants issued with the 2010 10% Notes agreement has a registration rights agreement that call for at any time during the period beginning December 31, 2011, until December 30, 2014, holders have a one-time right by written notice of no less than 50.1% of the securities and underlying securities included in the 2010 10% Note private placement to demand that the Company register all included and underlying securities. The Company believes this financing will provide working capital for use in connection with its short term business plan. The Company is pursuing other sources of financing to meet its obligations, repay its liabilities and fund the Company's business plan.

***Cashflows***

As of June 30, 2010, we had total cash on hand of \$431,386 and \$188,346 in restricted cash designated to pay the interest payments on the 10% Notes and the 2010 10% Notes and a working capital deficit of \$4,258,716.

During the six months ended June 30, 2010 and 2009, we had cash outflows from operations of \$1,280,897 and \$4,384,323, respectively. The decrease, when comparing the two periods, was primarily a result of our plans to reduce expenditures in order to conserve cash.

Cash flows used for investing activities decreased to \$27,057 during the six months ended June 30, 2010 from \$52,122 during the six months ended June 30, 2009 as a result of decreased capital asset expenditures.

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Cash flows from financing activities increased to an inflow of \$1,250,650 during the six months ended June 30, 2010 from a net inflow of \$8,426 during the six months ended June 30, 2009 as a result of the following financings:

	<b>Six Months Ended June 30,</b>	
	<b>2010</b>	<b>2009</b>
Proceeds from issuance of 10% senior extendible deferred convertible notes and warrants (the 2010 10% Notes) .....	1,500,000	—
Change in restricted cash .....	(16,594)	—
Deferred private placement costs .....	(231,080)	—
All other, net .....	(1,676)	8,426
Net cash provided by financing activities .....	<u>\$ 1,250,650</u>	<u>\$ 8,426</u>

***Commitments***

There have been no significant changes to commitments by the Company from its annual report.

***Capital resources***

On June 30, 2010, we had stock options outstanding denominated in U.S. dollars to purchase 3,975,000 ordinary shares. In addition, we had stock options outstanding denominated in Canadian dollars to purchase 994,500 ordinary shares as of June 30, 2010. If exercised, these stock options would generate approximately \$1.7 million and CDN\$0.6 million in additional cash, respectively.

At June 30, 2010 we had warrants outstanding denominated in Canadian dollars which are exercisable for 15,163,617 ordinary shares and which, if exercised, would generate approximately CDN\$13.2 million in additional cash. In addition, at June 30, 2010, we had 26,297,523 warrants outstanding denominated in U.S. dollars that contain cashless exercise provisions, which, upon certain conditions, permit the holder to exercise their warrants on a net cash exercise basis and receive ordinary shares without payment of any cash consideration. It is unlikely that we will receive any of the approximately \$9.8 million potential total cash proceeds from the exercise of these warrants if they are exercised due to the aforementioned cashless exercise provisions.

In November 2009, the Company completed a private placement for the sale of \$1,703,880 in Senior Extendible Deferred Convertible Notes with an interest rate of 10% (the "10% Notes"). The 10% Notes matured on April 19, 2010 and were extended, subject to certain provisions, to September 30, 2010. As part of the terms related to extending the maturity date, the Company paid the noteholders a 2.5% extension fee (\$42,597) of the principal amount outstanding and issued 3,315,750 warrants. See Note 5 in the consolidated financial statements for additional information.

In March 2010, the Company completed a private placement for the sale of \$1,500,000 in convertible notes with an interest rate of 10% (the "2010 10% Notes"). After underwriting expenses, the Company received \$1,173,500 plus an additional amount of \$172,500 which was deposited into an escrow account to for interest payments. Interest is paid monthly from an escrow account funded by a deduction from the proceeds of the private placement to pay the interest to the 2010 10% Note holders for the first year. The 2010 10% Notes matured on August 10, 2010 and were extended, subject to certain provisions, to February 6, 2011. As part of the terms related to extending the maturity date, the Company paid the noteholders a 2.5% extension fee (\$37,500) of the principal amount outstanding and issued 2,055,000 warrants. The 2010 10% Notes can be prepaid at any time at 110% of the principal amount if on or

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before the maturity date and at 120% thereafter. See Note 5 in the consolidated financial statements for additional information.

The Company sought this financing to provide working capital for use in connection with its short term business plan. The Company is pursuing other sources of financing to meet its obligations, repay its liabilities and fund the Company's business plan. Additional financing sought by the Company may include the issuance of ordinary shares or debt instruments in order to meet its cash requirements and fund its business plan.

Our business plan implemented during the second quarter of 2009, called for maintaining the current level of customers until we obtain additional financing in order to fund customer growth and positive cash flow. We were not able to maintain our level of customers in the last half of 2009 and thus experienced a decline in customers from 34,000 at June 30, 2009, to 27,000 at December 31, 2009. Our business plan for 2010 calls for maintaining our current level of customers while we structure the Company for a cash-flow neutral and then a positive cash flow position from operations and then returning to growing our customers base beginning in the third quarter of 2010. We were not able to maintain our level of customers during the first six months of 2010 and our customers decreased to 21,000 at June 30, 2010.

We are dependent upon our existing cash balances, along with our expected cash flow generated from gross profits to satisfy our marketing expenditures, general and administrative expenses, debt payments, and cash interest payments relating to our current operations and planned growth during the short term. Based on the Company's current operating plan, its existing working capital will not be sufficient to meet the cash requirements to fund the Company's operating expenses, required and potential payments under the 10% Notes, and the 2010 10% Notes, and working capital requirements through December 31, 2010 without additional sources of cash and/or the deferral, reduction or elimination of significant planned expenditures.

These factors raise substantial doubt about our ability to continue as a going concern. The Company intends to secure additional working capital through the sale of additional debt or equity securities. However, there is no assurance that the Company would be able to obtain such financing on favourable terms, if at all, or to successfully further reduce costs in such a way that would continue to allow the Company to operate its business. No arrangements or commitments for any such financing are in place at this time, and we cannot give any assurances about the availability or terms of any future financing.

**Outstanding share data:**

We are authorized to issue up to 450,000,000 ordinary shares and up to 450,000,000 preferred shares. As of August 20, 2010, we have the following equity securities outstanding:

- 62,916,107 ordinary shares.
- 31,668,274 warrants, each of which is exercisable for one ordinary share at prices ranging from \$0.26 to \$0.90.
- 15,163,617 warrants, each of which is exercisable for one ordinary share at prices ranging from CDN\$0.60 to CDN\$0.90.
- 3,975,000 stock options, each of which is exercisable for one ordinary share at prices ranging from \$0.15 to \$0.60 per share.
- 994,500 stock options, each of which is exercisable for one ordinary share at CDN\$0.60 per share.
- convertible Notes convertible which conversion price may be determined by future events. If we assume the lowest conversion price available to the holders (the closing stock price on the day

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before the Notes were issued (\$0.2569 for 6,632,453 shares) and (\$0.365 for 4,109,576 shares), the Notes would convert into 10,742,029 ordinary shares.

**Off-balance sheet arrangements:**

We did not have off-balance sheet arrangements during the six months ended June 30, 2010 or as of December 31, 2009.

**Transactions with related parties:**

Except for the transactions described above, we have not been a party to any transactions with related parties during the six months ended June 30, 2010.

**Contingencies:**

The Company is involved in various other claims and legal actions in the ordinary course of business. In the opinion of management, the ultimate disposition of all of these matters will not have a material adverse effect on the Company's consolidated financial position, results of operations or cash flows.

**Recently adopted accounting pronouncements:**

**Accounting Standards Updates:**

In March 2010, an update was made to "*Derivatives and Hedging*". This update provides clarification and related additional examples to improve financial reporting by resolving potential ambiguity about the breadth of the embedded credit derivative scope exception. This update is effective for each reporting entity at the beginning of the first fiscal quarter beginning after June 15, 2010. We have adopted the provisions of this update as of June 30, 2010 and there was no material impact to our consolidated financial statements.

In April 2010, an update was made to "*Revenue Recognition — Milestone Method*". This update provides amendments to provide guidance on the criteria that should be met for determining whether the milestone method of revenue recognition is appropriate. A vendor can recognize consideration that is contingent upon achievement of a milestone in its entirety as revenue in the period in which the milestone is achieved only if the milestone meets all criteria to be considered substantive. This update is effective on a prospective basis for milestones achieved in fiscal years, and interim periods within those years, beginning on or after June 15, 2010. Earlier adoption is permitted. We have adopted the provisions of this update as of June 30, 2010 and there was no material impact to our consolidated financial statements.

In September 2009, an update was made to "*Fair Value Measurement and Disclosures — Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*", which permits entities to measure the fair value of an investment that is within the scope of the amendments in this update on the basis of net asset value per share of the investment (or its equivalent) if the net asset value of the investment (or its equivalent) is calculated in a manner consistent with the measurement principles of "*Financial Services — Investment Companies*" as of the reporting entity's measurement date, including measurement of all or substantially all of the underlying investments of the investee in accordance with "*Fair Value Measurements and Disclosures*" guidance. This update also requires disclosure by major category of investment about the attributes of investments within the scope of the update. This update is effective for interim and annual periods ending after December 15, 2009. We adopted the provisions of

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this update as of January 1, 2010 and it did not have a material impact to our condensed consolidated financial statements.

In June 2009, an update was made to "*Consolidation — Consolidation of Variable Interest Entities*", to replace the calculation for determining which entities, if any, have a controlling financial interest in a variable interest entity ("VIE") from a quantitative risk based calculation, to a qualitative approach that focuses on identifying which entities have the power to direct the activities that most significantly impact the VIE's economic performance and the obligation to absorb losses of the VIE or the right to receive benefits from the VIE. The update requires ongoing assessment as to whether an entity is the primary beneficiary of a VIE, modifies the presentation of consolidated VIE assets and liabilities, and requires additional disclosures about a company's involvement in VIEs. This update is effective for annual periods beginning after November 15, 2009, for interim periods within the first annual reporting period and for interim and annual periods thereafter. Earlier application is prohibited. We adopted the provisions this update as of January 1, 2010 and it did not have an impact to our condensed consolidated financial statements.

In August 2009, an update was made to ASC 820, "*Fair Value Measurement and Disclosures — Measuring Liabilities at Fair Value*", to provide clarification that, in circumstances in which a quoted price in an active market for the identical liability is not available, a reporting entity is required to measure fair value using the techniques stated in the update. The update also clarifies fair value calculation for a liability when a restriction exists that prevents the transfer of the liability. The update further clarifies that use of quoted market price for an identical liability or the quoted market price for the identical liability when traded as an asset in an active market when no adjustments to the quoted price of the asset are required are Level 1 fair value measurements. This update is effective for the first reporting period, including interim periods, beginning after issuance. We have adopted the provisions of this update as of September 30, 2009 and there is no material impact on our consolidated financial statements.

In June 2009, the Financial Accounting Standards Board ("FASB") issued *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles*. The FASB Accounting Standards Codification ("Codification" or "ASC") established the Codification as the source of authoritative U.S. GAAP, recognized by the FASB to be applied by nongovernmental entities. The FASB will no longer issue new standards in the form of statements, FASB Staff Positions, or Emerging Issues Task Force Abstracts; instead, it will issue Accounting Standards Updates. The FASB will not consider Accounting Standards Updates as authoritative in their own right; these updates will serve only to update the Codification, provide background information about the guidance, and provide bases for conclusions on the change(s) in the Codification. The Codification is effective for interim and annual periods ending after September 15, 2009. We have updated our disclosures and consolidated financial statements to reflect the new Codification.

In May 2009, the FASB issued guidance, generally codified under ASC Topic 855 "Subsequent Events" ("Topic 855"). This statement sets forth the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure, the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date, and the disclosures that an entity should make about events or transactions that occurred after the balance sheet date. It requires disclosure of the date through which an entity has evaluated subsequent events and the basis for that date, whether that date represents the date the financial statements were issued or were available to be issued. Topic 855 is effective for interim and annual periods ending after June 15, 2009. Our adoption of Topic 855 on June 30, 2009 did not have a material impact on our consolidated financial statements.

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**Accounting Standards Updates Not Yet Effective:**

In April 2010, an update was made to "*Compensation — Stock Compensation*". This update provides amendments to clarify that an employee share-based payment award with an exercise price denominated in the currency of a market in which a substantial portion of the entity's equity securities trades should not be considered to contain a condition that is not a market, performance, or service condition. Therefore, an entity would classify such an award as a liability if it otherwise qualifies as equity. This update is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2010. Earlier adoption is permitted. We will adopt the provisions of this update and do not anticipate a material impact to our consolidated financial statements.

In January 2010, an update was made to "*Fair Value Measurements and Disclosures*". This update requires new disclosures of transfers in and out of Levels 1 and 2 and of activity in Level 3 fair value measurements. The update also clarifies the existing disclosures for levels of disaggregation and about inputs and valuation techniques. This update is effective for interim and annual reporting periods beginning after December 15, 2009, except for disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements, which are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. We will adopt the provisions of this update and do not anticipate a material impact to our consolidated financial statements.

In October 2009, an update was made to "*Revenue Recognition — Multiple-Deliverable Revenue Arrangements*". This update amends the criteria in "*Multiple-Element Arrangements*" for separating consideration in multiple-deliverable arrangements and replaces the term fair value in the revenue allocation guidance with selling price to clarify that the allocation of revenue is based on entity-specific assumptions rather than assumptions of a marketplace participant. This update establishes a selling price hierarchy for determining the selling price of a deliverable, eliminates the residual method of allocation and significantly expands the disclosures related to a vendor's multiple-deliverable revenue arrangements. This update is effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. We are currently in the process of evaluating the impact on our condensed consolidated financial statements.

**Financial instruments and other instruments:**

We use various types of financial instruments to fund our business capital requirements, including convertible debt and redeemable convertible preferred shares indexed to the market price of our ordinary shares. We evaluate these financial instruments to determine whether derivative features embedded in host contracts require bifurcation and fair value measurement. As a result of our evaluation, our convertible debentures and our redeemable convertible preferred shares did not require bifurcation and fair value measurement of derivative features. In November 2009, we completed a private placement for the sale of senior extendible deferred convertible notes (the, "10% Notes") that were determined to have a beneficial conversion feature because the conversion price was less than the market value of the Company's ordinary shares at the time of issuance.

We incurred debt offering costs related to the issuance of the 10% Notes and the 2010 10% Notes, and these costs are capitalized as debt offering costs on the consolidated balance sheets and are charged to interest expense using the straight-line method which approximates the effective interest method over the life of the Notes. During the three and six months ended June 30, 2010, we recognized non-cash interest expense of \$157,201 and \$421,133, respectively, relating to amortization of the debt offering costs related to the 10% Notes and 2010 10% Notes. Unamortized debt offering costs were \$34,056 at June 30, 2010.

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The detachable warrants and placement agent warrants have been valued separately at fair value using the Black-Scholes methodology. As of March 2010 and October 2009, the fair value calculations assumed a risk-free interest rate of 2.35% and 2.3%, respectively, estimated expected volatility of 50% and 38%, respectively and no dividends. The value assigned to the detachable warrants and placement agent warrants during March 2010 and October 2009 is \$211,780 and \$310,530, respectively using the Black-Scholes option-pricing model and is included in derivative contract liabilities on the Company's consolidated balance sheets.

Original debt discount of \$522,310 associated with our outstanding 10% Notes and the 2010 10% Notes represents the original fair value of the detachable warrants that were issued in conjunction with the Notes. This debt discount is amortized using the straight-line method, which approximates the effective interest method, as interest expense over the life of the Notes. During the three and six months ended June 30, 2010, we recognized non-cash interest expense applicable to discount amortization of \$139,912 and \$350,481, respectively.

The 10% Notes were determined to have a beneficial conversion feature because the conversion price was less than the market value of the Company's ordinary shares at the time of issuance. The intrinsic value assigned to the beneficial conversion feature during October 2009 is \$323,790 and is included in derivative contract liabilities on the Company's consolidated balance sheets. This debt discount is amortized using the straight-line method, which approximates the effective interest method, as interest expense over the life of the 10% Notes. During the three and six months ended June 30, 2010, we recognized non-cash interest expense applicable to discount amortization of \$34,151 and \$196,061, respectively.

During 2008, we issued 15,183,528 two-year detachable warrants to purchase our ordinary shares at exercise prices ranging from CND\$0.60 to CND\$0.90. Since these warrants are denominated in a currency that is different from our functional currency (the U.S. dollar) the fair value of these warrants are recorded as a derivative contract liability and the fair value is re-measured at the end of each reporting period with any change in fair value recorded as a gain or loss on derivative contract liability in our consolidated statements of operations. The fair value of the derivative contract liabilities is measured using the Black-Scholes valuation model.

We have limited exposure to credit risk as sales to customers are usually immediately paid by credit card. Our reserve for refunds and credit card charge backs was \$5,666 at June 30, 2010 and our accounts receivable balance was \$108,991 at June 30, 2010. Currently, we do not have significant credit risk exposure due to the small magnitude of these balances and the nature of our operations.

Currently, our interest rate risk exposure is limited as all our outstanding debt at June 30, 2010 has fixed interest rates and the impact of interest rate changes on our other financial instruments (mainly derivative contract liabilities) would be minimal.

The fair market value of our derivative contract liabilities is very sensitive to the market price of our ordinary shares and our estimate of share price volatility. Our consolidated audited financial statements for the year ended December 31, 2009 and related MD&A contains additional information regarding our derivative contract liabilities. Additional information may be found in these reports.

**Outlook:**

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We are a start-up company. As such, key statistics such as customer retention rates, cost of customer acquisition, and lifetime revenue per customer are not yet well established.

Our future revenues depend on the successful marketing of our services. Our marketing campaigns have to attract sufficient business to produce revenue that will enable us to meet our operating expenses and fund our future growth plans. As of June 30, 2010, we had approximately 21,000 customers with active subscriptions. Our active customer count is down at June 30, 2010 as compared to 40,000 at June 30, 2009. An active customer is defined as a customer who has paid monthly subscription fee and is no more than 60 days past due.

We are also facing new and existing competitors engaged in providing solutions for identity theft. Our future operations will require monitoring the marketplace for items such as service pricing, service innovations and marketing strategies.

Because we have been in commercial operation for a short period of time, our revenue, cost of revenue, gross profit and net loss reported for the three and six months ended June 30, 2010, may not be indicative of future results. We have invested in our infrastructure in order to make the delivery of our services highly automated and, therefore, if we grow our customer base, we expect that our gross profits will improve as our revenue growth expands. We are dependent upon our existing cash balances, along with our expected cash flow generated from gross profits to satisfy our marketing expenditures, general and administrative expenses, debt payments, and cash interest payments relating to our current operations and planned growth during the short term.

These factors raise substantial doubt about our ability to continue as a going concern. The Company intends to secure additional working capital through the sale of additional debt or equity securities. However, there is no assurance that the Company would be able to obtain such financing on favourable terms, if at all, or to successfully further reduce costs in such a way that would continue to allow the Company to operate its business. No arrangements or commitments for any such financing are in place at this time, and we cannot give any assurances about the availability or terms of any future financing.

**Forward-looking statements:**

Our MD&A contains "forward-looking information" that is based on ID Watchdog, Inc.'s expectations, estimates and projections as of the dates as of which those statements were made. This forward-looking information includes, among other things, statements with respect to ID Watchdog, Inc.'s business and marketing strategies, plans, outlook, services, projections, targets and expectations as to future revenue, gross profit margins, liquidity and cash flow from operations, working capital requirements, projections regarding new customers, active customers and customer retention rates, currency exchange rates, expectations regarding industry trends, and competitive position in the marketplace. Generally, this forward-looking information can be identified by the use of forward-looking terminology such as "outlook", "anticipate", "project", "target", "believe", "estimate", "expect", "intend", "should", "scheduled", "will", "plan" and similar expressions. Forward-looking information is subject to known and unknown risks, uncertainties and other factors that may cause ID Watchdog, Inc.'s actual results, level of activity, performance or achievements to be materially different from those expressed or implied by such forward-looking information, including but not limited to:

- Uncertainties related to and our limited operating history;
- Uncertainties associated with sufficient operating income and future losses;
- Uncertainties associated with marketing studies and strategies;

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- Uncertainties associated with market acceptance of our services;
- Uncertainties associated with market competition;
- Uncertainties over future products we envisage from our new Acxiom relationship may never achieve market acceptance;
- Risks related to operating in consumer information services regulated by federal and state laws of consumer data and consumer advertising;
- Risks related to a responsibility to secure active and former customer data from any potential data breach and any costs to compensate the customer for such breach;
- Uncertainties associated with general economic conditions;
- Uncertainties related to our dependence upon outside suppliers to provide us databases which enable us to provide our services to customers;
- Reliance upon merchant banks to process credit card payments;
- Risks related to credit card payment processing rules and restrictions relating to excessive chargebacks;
- Uncertainties pertaining to our ability to protect our intellectual property including service marks, trademarks and patents;
- Uncertainties relating to claims from others that our intellectual property has infringed on the proprietary right of others;
- Changes in laws that allow consumers to access personal information records and give consumers the right to request correction of inaccurate records;
- Interpretations of insurance and credit services regulations that would cause our services to be subject to such regulations;
- Uncertainties related to obtaining additional funding;
- Uncertainties related to fluctuations in Canadian and US dollar exchange rates;
- Uncertainties related to adequacy or effectiveness of internal controls;
- Reliance on key personnel; and
- Uncertainties related to legal proceedings.

A discussion of these and other factors that may affect our actual results, performance, achievements or financial position is contained in our filings with the Canadian provincial securities regulatory authorities. This list is not exhaustive of the factors that may affect our forward-looking information. These and other factors should be considered carefully and readers should not place undue reliance on such forward-looking information. Forward-looking statements contained in this MD&A are based on the beliefs, expectations and opinions of management on the date the statements are made, and the company does not assume any obligation to update forward-looking statements if circumstances or management's beliefs, expectations or opinions should change, except as required by law.