

*Consolidated Financial Statements of*

**TELEHOP COMMUNICATIONS INC.**

*December 31, 2008 and 2007*



# Schwartz Levitsky Feldman llp

CHARTERED ACCOUNTANTS  
LICENSED PUBLIC ACCOUNTANTS  
TORONTO • MONTREAL

## AUDITORS' REPORT

To the Shareholders of  
Telehop Communications Inc.

We have audited the consolidated balance sheets of Telehop Communications Inc. as at December 31, 2008 and 2007 and the consolidated statements of operations and comprehensive loss, retained earnings and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2008 and 2007 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

### **"SCHWARTZ LEVITSKY FELDMAN LLP"**

Toronto, Ontario  
March 9, 2009

Chartered Accountants  
Licensed Public Accountants

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# TELEHOP COMMUNICATIONS INC.

## Consolidated Balance Sheets

As at December 31, 2008 and 2007

	2008	2007
<b>ASSETS</b>		
<b>CURRENT</b>		
Cash and cash equivalents (Note 5)	\$ 1,273,585	\$ 2,882,305
Accounts receivable (net of allowance for doubtful accounts of Nil in 2008; \$74,648 in 2007)	2,373,500	2,875,202
Income taxes recoverable	821,409	291,495
Prepaid expenses and deposits	156,994	88,246
	<b>4,625,488</b>	<b>6,137,248</b>
PROPERTY AND EQUIPMENT (Note 7)	576,154	769,346
INTANGIBLE ASSETS (Note 8)	161,234	267,454
	<b>\$ 5,362,876</b>	<b>\$ 7,174,048</b>
<b>LIABILITIES</b>		
<b>CURRENT</b>		
Accounts payable and accrued liabilities	\$ 2,324,190	\$ 2,565,416
Dividend payable	-	267,270
Obligations under capital lease (Note 9)	16,526	15,253
	<b>2,340,716</b>	<b>2,847,939</b>
FUTURE INCOME TAXES (Note 6)	38,678	32,284
OBLIGATIONS UNDER CAPITAL LEASE (Note 9)	28,921	47,185
	<b>2,408,315</b>	<b>2,927,408</b>
<b>SHAREHOLDERS' EQUITY</b>		
SHARE CAPITAL (Note 10)	1,555,644	1,527,177
CONTRIBUTED SURPLUS (Note 10(c))	55,497	40,489
RETAINED EARNINGS	1,343,420	2,678,974
	<b>2,954,561</b>	<b>4,246,640</b>
	<b>\$ 5,362,876</b>	<b>\$ 7,174,048</b>

Commitments (Note 15)

Related Party Transactions (Note 16)

Contingent Liability (Note 17)

*The accompanying notes are an integral part of these consolidated financial statements*

APPROVED BY THE BOARD

"Hersh Spiegelman"

Chairman of the Board

"Stan Katz"

Director



# TELEHOP COMMUNICATIONS INC.

## Consolidated Statements of Operations and Comprehensive Loss

Years ended December 31, 2008 & 2007

	2008	2007
OPERATING REVENUES	\$ 16,384,290	\$ 17,983,269
Telecommunications costs	10,257,246	10,554,593
GROSS MARGIN	6,127,044	7,428,676
OPERATING EXPENSES		
General and administration	4,260,064	3,220,896
Marketing and selling	2,493,450	2,580,811
Development and technical support	1,034,913	952,495
Amortization	419,609	461,798
Write-down of intangible assets	39,354	-
Interest	2,648	29,221
	8,250,038	7,245,221
OPERATING INCOME (LOSS)	(2,122,994)	183,455
Other income	69,653	165,077
INCOME (LOSS) BEFORE INCOME TAXES	(2,053,341)	348,532
Income taxes (recovery) (Note 6)	(717,787)	175,784
NET INCOME (LOSS)	(1,335,554)	172,748
Other comprehensive income	-	-
COMPREHENSIVE INCOME (LOSS)	(1,335,554)	172,748
EARNINGS (LOSS) PER SHARE (Note 12)	\$ (0.10)	\$ 0.01
DILUTED EARNINGS (LOSS) PER SHARE (Note 12)	\$ (0.10)	\$ 0.01

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

**APPROVED BY THE BOARD**

"Hersh Spiegelman"

"Stan Katz"

**Chairman of the Board**

**Director**



# TELEHOP COMMUNICATIONS INC.

## Consolidated Statements of Retained Earnings

Years ended December 31, 2008 & 2007

	2008	2007
Retained earnings, beginning of year	\$ 2,678,974	\$ 2,773,496
Net income (loss) for the year	(1,335,554)	172,748
Dividend declared	-	(267,270)
Retained earnings, end of year	\$ 1,343,420	\$ 2,678,974

*The accompanying notes are an integral part of these consolidated financial statements*

**APPROVED BY THE  
BOARD**

*"Hersh Spiegelman"*      **Chairman of the Board**

*"Stan Katz"*              **Director**



# TELEHOP COMMUNICATIONS INC.

## Consolidated Statements of Cash Flows

Years ended December 31, 2008 and 2007

	2008	2007
<b>CASH FLOW PROVIDED BY (USED FOR)</b>		
<b>OPERATING ACTIVITIES</b>		
Net income (loss) for the year	\$ (1,335,554)	\$ 172,748
Adjustments for non-cash items:		
Amortization expense	419,609	461,798
Writedown of intangible assets	39,354	
Future income tax provision	6,394	(36,766)
Stock-based compensation	26,747	(49,063)
	<b>(843,450)</b>	548,717
Changes in working capital items:		
Accounts receivable	501,702	444,157
Prepaid expenses and deposits	(68,748)	148,635
Accounts payable and accrued liabilities	(241,226)	(328,239)
Income taxes recoverable	(529,914)	(478,805)
Cash provided (used) by operating activities	<b>(1,181,636)</b>	334,465
<b>INVESTING ACTIVITIES</b>		
Acquisitions of property and equipment	(90,680)	(211,987)
Acquisition of intangible assets	(68,870)	(52,635)
Cash used by investing activities	<b>(159,550)</b>	(264,622)
<b>FINANCING ACTIVITIES</b>		
Capital lease payments	(16,991)	(3,667)
Dividend paid	(267,270)	(127,035)
Buy back of company shares	(773)	-
Issuance of common shares	17,500	164,500
Cash used by financing activities	<b>(267,534)</b>	33,798
INCREASE (DECREASE) IN CASH POSITION	<b>(1,608,720)</b>	103,641
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	<b>2,882,305</b>	2,778,664
CASH AND CASH EQUIVALENTS, END OF YEAR	<b>\$ 1,273,585</b>	\$ 2,882,305



SUPPLEMENTARY DISCLOSURE OF CASH FLOW INFORMATION

Non-cash Financing Activities

Dividends payable	\$	-	\$	267,270
Contributed surplus allocated to share capital on exercise of employee stock options during the year	\$	-	\$	84,709
Obligations under capital lease	\$	45,447	\$	62,438

*The accompanying notes are an integral part of these consolidated financial statements*

**APPROVED BY**

**THE BOARD**

*"Hersh Spiegelman"*      **Chairman of  
the Board**  
*"Stan Katz"*            **Director**

**TELEHOP COMMUNICATIONS INC.**  
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**NATURE OF BUSINESS**

**1** Telehop Communications Inc. (the Company) is a full-service long distance provider operating within the telecommunications industry and is registered with the Canadian Radio-television and Telecommunications Commission (“CRTC”) as a licensed Class ‘A’ Telecom Carrier.

**2. SIGNIFICANT ACCOUNTING POLICIES**

The consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles (GAAP) and reflect the following policies:

*(i) Basis of consolidation*

The consolidated financial statements include the accounts of the Company and its subsidiaries, all of which are wholly owned, of which the principal company is Telehop Communications Inc. All inter company transactions and accounts have been eliminated on consolidation.

*(ii) Use of estimates*

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Given the use of estimates inherent in the financial reporting process, actual results could differ from those estimates. Examples of significant estimates include:

- Allowance for doubtful accounts
- Estimated useful lives of assets
- Recoverability of intangible and tangible assets
- The amount of income tax assets and liabilities
- Certain actuarial and economic assumptions used in defining defined benefit pension costs, accrued pension obligations and pension plan assets

*(iii) Cash and cash equivalents*

For purposes of the consolidated financial statements, cash and cash equivalents is defined as cash and short-term investments having a maturity of three months or less.

*(iv) Impairment of long-lived assets*

When events or changes in circumstances indicate the carrying amount of a long-lived asset may not be recoverable, an impairment loss is recognized when the carrying amount of



**TELEHOP COMMUNICATIONS INC.**  
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those assets exceeds the sum of the undiscounted future cash flows related to them. The impairment loss is included in the consolidated statements of operations and comprehensive loss and the carrying value of the asset is reduced to its fair value as determined by the sum of the discounted future cash flows related to those assets. For the year ended December 31, 2008, there were no impairment losses recognized in the consolidated statements of operations and comprehensive loss.

*(v) Property and equipment*

Property and equipment are recorded at cost and are amortized based on the estimated useful lives of the assets using the straight-line method over the following periods:

Telecom equipment	- 5 years
Furniture and equipment	- 5 years
Computer Equipment	- 3 years
Leasehold improvements	- 5 years
Telecom switch equipment	- 7 years
Computer software	- 5 years

*(vi) Intangible assets*

Intangible assets are comprised of the following items: a system for telephone call data management and billing, a system for enhanced accounting and financial reporting, and software licenses for soft phones. All intangible assets are amortized over their estimated useful life on a straight-line basis over 5 years. Management reviews the intangible assets for amortization and useful life annually and also for impairment whenever events or changes in circumstances indicate that full recoverability is questionable. Management measures any potential impairment by comparing the carrying value to the undiscounted amounts of expected future cash flows.

*(vii) Translation of foreign currencies*

Monetary assets and liabilities denominated in foreign currencies are translated at exchange rates in effect at the balance sheet date with any resulting gain or loss being included in the consolidated statements of operations and comprehensive loss. Trade transactions are translated at exchange rates prevailing during the period.

*(viii) Employee future benefits*

The cost of providing benefits through defined benefit pensions is actuarially determined and recognized in earnings using the projected benefits method pro-rated on service. Differences arising from plan amendments, changes in assumptions and experience gains and losses are recognized in earnings over the expected average remaining service life of employees. Actuarial gains and losses that fall outside a corridor defined as the greater of (a) 10% of the accrued benefit obligation and (b) 10% of the fair market value of the plan



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assets at the beginning of the year are amortized over the average remaining service period of active employees on a straight-line basis. The expected return on plan assets is based on the fair value of plan assets.

*(ix) Income taxes*

The Company uses the asset and liability method for accounting for income taxes which requires the establishment of future tax assets and liabilities, as measured by substantively enacted tax rates, for all temporary differences caused when tax bases of assets and liabilities differ from those reported in the financial statements. Future tax assets are recognized only to the extent that, in the opinion of management, it is more likely than not that the future income tax assets will be realized. Future tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of substantive enactment.

*(x) Revenue recognition*

The Company earns its revenues from access to, and usage of, its telecommunications network. Its main service is to provide long-distance services through the access of our network, which has the capability to track pertinent data for each individual call to a particular country destination. This allows the Company to rate each call by applying pre-determined long-distance rates by country to the volume of minutes provided. The Company recognizes revenues on the accrual basis and includes an estimate of revenues earned but not billed. Revenue is only recognized where there is persuasive evidence of an arrangement exists, services have been rendered and a price to the customer is fixed or determinable. There were no revenue arrangements with multiple deliverables during the year. The Company's services are packaged in different forms which include casual calling, subscriptions (equal access service and Telehop HomePhone) and wholesale.

*(a) Casual Calling*

This service allows customers to access the Company's network without the need to subscribe to the service, sign a contract or pay any direct fees. Customers can complete a long-distance call by dialing one of two carrier identification codes (CIC), "10-10-100" or "10-10-620", that are owned by the Company. Revenue is recognized when a customer dials our CIC's and completes a connected long-distance call.

*(b) Subscriptions*

Equal access service- This service allows a customer to directly dial their long distance number, by dialing "1+" or "011+". The customer subscribes to this service and is required to transfer carriers upon sign up. Revenue is recognized when a customer completes a long-distance call as access and usage of the Company's network has occurred.



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Telehop HomePhone – The Company markets a VoIP (voice-over-INTERNET-protocol) service under its Telehop HomePhone brand. This service allows a customer to place local and long-distance calls through a high-speed INTERNET connection; thus, allowing the customer to replace their home phone. Revenue is recognized when the customer is billed each month for usage of the service.

*(c) Wholesale*

The Company offers discounted rates to high volume users who typically want to carry their calls through the Company's network. Bulk minutes are sold by destination to these users who frequently repackage them with their own unique services which are then sold to their customers. Revenue is recognized when the reseller's customers make long-distance calls through the access and usage of the Company's network.

*(xi) Telecommunications costs*

Telecommunications costs primarily include fixed and variable carrier costs, billing and collections charges from Local Exchange Carriers (LECs) and operating lease expenses related to telecommunications equipment facilities.

*(xii) Stock-based compensation*

The Company has an employee share option plan, which is described in Note 10. Canadian GAAP requires that all share-based awards made to employees and non-employees be measured and recognized in the financial statements using a fair value based method, such as the Black-Scholes option pricing model. Proceeds arising from the exercise of share options are credited to share capital. When stock-based compensation vests in fixed amounts at a future point in time, the expense is recognized by the Company in the Consolidated Statements of Operations and Comprehensive Loss on a straight-line basis over the vesting period. Refer to Note 10 (b) for additional disclosure on stock-based compensation.

*(xiii) Earnings per share*

The Company uses the treasury stock method of calculating the dilutive effect of options on earnings per share, whereby any proceeds obtained upon exercise of options is assumed to be used to purchase common shares at the average market share price during the period, except in the instance where such a calculation would be anti-dilutive.

*(xiv) Leases*

Leases are classified as capital or operating depending upon the terms and conditions of the contracts. Asset values recorded under capital leases are amortized on a straight-line basis over the period of expected use. Obligations recorded under capital leases are reduced by lease payments net of imputed interest.



### **3. CHANGES IN ACCOUNTING POLICIES**

Effective January 1, 2007, the Company adopted five new accounting standards that were issued by the Canadian Institute of Chartered Accountants (“CICA”): *Comprehensive Income* (“Section 1530”), *Hedges* (“Section 3865”), *Financial Instruments – Recognition and Measurement* (“Section 3855”), *Equity* (“Section 3251”), and *Financial Instruments – Disclosure and Presentation* (“Section 3861”). These new Handbook Sections, which apply to fiscal years beginning on or after October 1, 2006, provide comprehensive requirements for the recognition and measurement of financial instruments, as well as standards on when and how hedge accounting may be applied. These accounting policy changes were adopted on a prospective basis with no restatement of prior period financial statements.

#### *(i) Comprehensive Income*

Section 1530 requires the presentation of comprehensive income, which consists of net income and other comprehensive income (“OCI”). Comprehensive income is defined as the change in equity from transactions and other events from non-owner sources. OCI refers to items recognized in comprehensive income but that are excluded from net income calculated in accordance with generally accepted accounting principles. A new financial statement has been presented in relation to the new standards.

#### *(ii) Financial Instruments – Recognition and Measurement and Disclosure and Presentation*

Section 3855 establishes standards for recognizing and measuring financial assets, financial liabilities and non-financial derivatives. All financial assets and financial liabilities, including derivatives, are measured in the balance sheet at fair value, except for loans and receivables, investments held-to-maturity and other financial liabilities, which are measured at amortized cost.

Measurement in subsequent periods depends on whether the financial instrument had been classified as held-for-trading, available-for-sale, held-to-maturity, loans and receivables, or other liabilities.

Held-for-trading financial investments are measured at fair value and all gains and losses are included in net income in the period in which they arise. Available-for-sale financial instruments are measured at fair value with revaluation gains and losses included in other comprehensive income until the assets are removed from the balance sheet. All changes in the fair value of derivatives are recognized in earnings unless specific hedge criteria are met in accordance with Section 3865 which requires that a company must formally document, designate and assess the effectiveness of transactions that receive hedge accounting.

The Company has elected to apply the following classifications to each of its significant categories of financial instruments:

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<u>Asset/Liability</u>	<u>Category</u>	<u>Measurement</u>
Cash and cash equivalents	Held for trading	Fair value
Accounts receivable	Loans and receivables	Amortized cost
Accounts payable and accrued liabilities	Other liabilities	Amortized cost

As a result of the adoption of these standards, the company designated its cash and cash equivalents as held-for-trading. Held-for-trading financial assets are measured at fair value with unrealized gains and losses recognized in the consolidated statement of operations and comprehensive loss. Accounts receivable are classified as loans and receivables, which are measured at amortized cost. Accounts payable and accrued liabilities are classified as financial liabilities, which are measured at amortized cost.

The company classifies derivative instruments, such as foreign exchange forward contracts and foreign exchange options contracts, as held-for-trading unless the instruments meet all the criteria of a hedge. If the criteria are met, then any unrealized gains and losses will be reported in other comprehensive income.

*Capital Disclosures and Financial Instruments – Disclosure and Presentation*

Effective January 1, 2008, the Company adopted new accounting standards that were issued by the CICA for Capital Disclosures (“Section 1535”) and Financial Instruments (“Sections 3862 and 3863”).

(i) Under Section 1535, the Company discloses its objectives, policies and procedures for managing capital, whether the Company has complied with any externally imposed capital requirements and, if the Company has not complied with them, any consequences of non-compliance with these capital requirements. The new recommendations are set out in Note 14 – Capital Management.

(ii) The new Sections 3862 and 3863 replace Section 3861 (“*Financial Instruments – Disclosure and Presentation*”). Disclosure requirements are revised and enhanced, while presentation requirements remain essentially unchanged. The new disclosure requirements expand discussion around the significance of financial instruments for the Company’s financial position and performance, the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the balance sheet date and how the entity manages those risks. The new recommendations are set out in Note 13 – Financial Instruments and Risk Management.



#### **4. DEVELOPMENT IN ACCOUNTING POLICIES**

*(i) Goodwill and Intangible Assets*

In January, 2008, the CICA issued Handbook Section 3064 (“*Goodwill and Intangible Assets*”), replacing Section 3062 (“*Goodwill and Other Intangible Assets*”), and Section 3450 (“*Research and Development Costs*”). The new Section 3064 addresses when an internally developed intangible asset meets the criteria for recognition of an asset.

The Section also issued amendments to Section 1000 (“*Financial Statement Concepts*”). These changes are effective for fiscal years on or after October 1, 2008, specifically January 1, 2009 for the Company. The Company does not expect the adoption of this standard to have a significant impact.

*(ii) Assessing Going Concern*

Effective January 1, 2008 the Company adopted the new recommendations of CICA Handbook Section 1400, General Standards of Financial Statement Presentation, to include requirements for management to assess and disclose an entity’s ability to continue as a going concern. The Company has assessed the impact of adopting Section 1400 and has determined that it does not impact the Company’s financial statements.

*(iii) Convergence with International Financial Reporting Standards*

In February 2008, the Accounting Standards Board (“AcSB”) confirmed that the use of IFRS will be required in 2011 for publicly accountable enterprises in Canada. In April 2008, the AcSB issued an IFRS Omnibus Exposure Draft proposing that publicly accountable enterprises be required to apply IFRS, in full and without modification, on January 1, 2011. The adoption date of January 1, 2011 will require the restatement, for comparative purposes, of amounts reported by the Company for its year ended December 31, 2010, and of the opening balance sheet as at January 1, 2010. The AcSB proposes that CICA Handbook Section, Accounting Changes, paragraph 1506.30, which would require an entity to disclose information relating to a new primary source of GAAP that has been issued but is not yet effective and that the entity has not applied, not be applied with respect to the IFRS Omnibus Exposure Draft. The Company is continuing to assess the financial reporting impacts of the adoption of IFRS and, at this time, the impact on future financial position and results of operations is not reasonably determinable or estimable. The Company does anticipate a significant increase in disclosure resulting from the adoption of IFRS and is continuing to assess the level of disclosure required, as well as system changes that may be necessary to gather and process the required information.

*(iv) Consolidated Financial Statements and Non-Controlling Interests*

**TELEHOP COMMUNICATIONS INC.**  
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CICA HB Section 1601, Consolidated Financial Statements and HB Section 1602, Non-controlling Interests replace CICA HB Section 1600, Consolidated Financial Statements. HB Section 1601 establishes standards for the preparation of consolidated financial statements. HB Section 1602 establishes standards for accounting for a non-controlling interest in a subsidiary in consolidated financial statements subsequent to a business combination. HB Section 1602 is equivalent to the corresponding provisions of International Financial Reporting Standard IAS 27, Consolidated and Separate Financial Statements. These standards are effective for interim and annual financial statements beginning on or after January 1, 2011, which for this Company is January 1, 2011. The Company has not yet determined the impact of the adoption of these changes on its Financial Statements.

*(v) Business combinations*

In January 2009, the CICA issued Section 1582, Business Combinations. This section is effective January 1, 2011 and applies prospectively to business combinations for which the acquisition date is on or after the first annual reporting period of the Corporation beginning on or after January 1, 2011, which for this Company is January 1, 2011. Early adoption is permitted. This section replaces Section 1581, Business Combinations and harmonizes the Canadian standards with international financial reporting standards (IFRS). The Company does not anticipate that the adoption of this standard will impact its financial results.

*(vi) Inventories*

Effective January 1, 2008, the company adopted the new recommendations of the CICA Handbook Section 3031, Inventories, that replaces Section 3030 and establishes new standards for the measurement and disclosure of inventories. The main features of the new Section are as follows:

1. Measurement of inventories at the lower of cost and net realizable value
2. Consistent use of either first-in, first-out or a weighted average cost formula to measure cost
3. Reversal of previous write-downs to net realizable value when there is a subsequent increase to the value of inventories.

The adoption of this standard had no impact on the Company.

**5. CASH AND CASH EQUIVALENTS**



**TELEHOP COMMUNICATIONS INC.**  
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	<b>2008</b>	2007
Operating cash	\$ <b>684,853</b>	\$ 446,602
Short-term investments	<b>588,732</b>	2,435,703
	<b>\$ 1,273,585</b>	\$ 2,882,305

Short-term investments consist of term deposits and bankers acceptances with maturities less than three months. No asset-backed commercial papers were held at any time during the year.

**6. INCOME TAXES**

*(i) Income tax expense*

The income tax expense for the years ended December 31, 2008 and 2007 are as follows:

	<b>2008</b>	2007
Current	\$ <b>(703,000)</b>	\$ 149,146
Future	<b>6,394</b>	(36,766)
	<b>(696,606)</b>	112,380
Prior years' income tax reassessment	<b>(21,181)</b>	63,404
	<b>\$ (717,787)</b>	\$ 175,784

*(ii) Future income taxes*

Future income tax assets and liabilities as at December 31, 2008 and 2007 were as follows:

	<b>2008</b>	2007
Future income tax liability		
Accounting base of property and equipment in excess of tax value	<b>\$ 38,678</b>	\$ 32,284
Long-term	<b>\$ 38,678</b>	\$ 32,284

*(iii) Reconciliation of provisions to statutory rates*

The reconciliation of income taxes at Canadian statutory rates to the provision for income taxes is as follows:

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	2008	2007
Net income (loss) before income taxes	\$ (2,053,341)	\$ 348,532
Approximate applicable statutory tax rate	33.50%	36.12%
Income taxes at statutory tax rates	(687,869)	125,890
Prior years' reassessments	(21,180)	63,404
Other	(8,738)	(13,510)
	\$ (717,787)	\$ 175,784

**7. PROPERTY AND EQUIPMENT**

	2008			2007		
	Cost	Accumulated Amortization	Net Book Value	Cost	Accumulated Amortization	Net Book Value
Telecom equipment	\$ 889,923	\$ 624,172	\$ 265,751	\$ 1,191,183	\$ 766,404	\$ 424,779
Telecom equipment under capital lease	66,105	20,658	45,447	66,105	4,861	61,244
Computer software	240,143	131,453	108,690	262,330	117,609	144,721
Computer Equipment	87,601	24,440	63,161	27,327	4,878	22,449
Leasehold improvements	80,381	32,451	47,930	162,947	98,575	64,372
Furniture and equipment	66,572	21,397	45,175	114,499	62,718	51,781
	\$ 1,430,725	\$ 854,571	\$ 576,154	\$ 1,824,391	\$ 1,055,045	\$ 769,346

Amortization expense for the year ended December 31, 2008 was \$283,872 (2007 - \$318,289). During the year, fully amortized assets totaling \$514,552 (2007 - \$1,381,340) were removed from cost and accumulated amortization. Amortization expense relating to assets under capital lease was \$15,797 (2007 - \$4,861).



**TELEHOP COMMUNICATIONS INC.**  
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**8. INTANGIBLE ASSETS**

	2008			2007		
	Cost	Accumulated Amortization	Net Book Value	Cost	Accumulated Amortization	Net Book Value
Internally Developed	\$ 294,007	\$ 132,773	\$ 161,234	\$ 687,268	\$ 461,851	\$ 225,417
Software Licenses	-	-	-	53,664	11,627	42,037
	<b>\$ 294,007</b>	<b>\$ 132,773</b>	<b>\$ 161,234</b>	<b>\$ 740,932</b>	<b>\$ 473,478</b>	<b>\$ 267,454</b>

Amortization expense for the year ended December 31, 2008 was \$175,091 (2007 - \$143,509). During the year, fully amortized assets totaling \$462,131 (Nil in 2007) were removed from cost and accumulated amortization. During the year there was a write down of intangible assets of \$39,354 (2007 - Nil).

**9. CAPITAL LEASE OBLIGATIONS**

The company entered into a lease during 2007 for telecommunications equipment that had been capitalized. The security value of the capital equipment is \$77,771, and the maturity date of the lease is September, 2011. The interest expense for 2008 was \$2,916 (2007 - \$729).

	2008	2007
Total minimum lease payments	\$ 53,467	\$ 72,910
Less: amount representing imputed interest of 6.2%	8,020	10,472
Present value of obligations under capital lease	45,447	62,438
Current portion - due within one year	16,526	15,253
Long-term obligations under capital lease	\$ 28,921	\$ 47,185



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**10. SHAREHOLDERS' EQUITY**

Authorized:

An unlimited number of common shares issued and outstanding

The changes in common shares for 2008 and 2007 are as follows:

	2008		2007	
	No. of Shares	Amount	No. of Shares	Amount
Balance, beginning of year	13,363,500	\$ 1,527,177	12,703,500	\$ 1,277,968
Buy back of common shares (Note 10 (a))	(3,500)	(403)		
Issued on exercise of employee stock options (Note 10(b))	50,000	28,870	660,000	249,209
Balance, end of year	13,410,000	\$ 1,555,644	13,363,500	\$ 1,527,177

*(a) Normal course issuer bid*

The Company has authorized a normal course issuer bid for up to 650,000 common shares, which is approximately 5% of the 13,410,000 issued and outstanding common shares. Telehop's normal course issuer bid will be made in accordance with the by-laws, rules and policies of the Toronto Stock Exchange. The Company has plans to re-purchase common shares at prevailing market prices over a twelve-month period which commenced November 10, 2008. Purchases under the bid can be made from time to time over this twelve-month period, as appropriate opportunities arise.

*(b) Stock options*

The Company's employee stock option plan ("ESOP") authorized the Company to reserve 1,800,000 common shares of the Company for issuance in accordance with the terms of the ESOP. Options granted vest over a period not exceeding five years and the purchase price is payable in full at the time the options are exercised. In the event of a reorganization, consolidation or change in control, the optionee has the right to exercise the share option.



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The following table presents information concerning stock options granted under the Company's stock option plan:

	2008		2007	
	Number of options	Weighted Average Exercise Price	Number of options	Weighted Average Exercise Price
Options outstanding, beginning of year	355,000	\$ 0.55	1,115,000	\$ 0.26
Options granted	-	-	200,000	0.70
Options exercised	(50,000)	0.35	(660,000)	0.25
Options cancelled	(205,000)	0.57	(300,000)	0.31
Options outstanding, end of year	100,000	\$ 0.60	355,000	\$ 0.55
Options exercisable, end of year	60,000	\$ 0.60	155,000	\$ 0.35

The following table summarizes information about stock options outstanding at December 31, 2008:

Options Outstanding			Options Exercisable	
Weighted Average Exercise Price	Number Outstanding	Weighted Average Remaining Contractual Life (years)	Number Exercisable	Weighted Average Exercise Price
\$ 0.60	100,000	3.98	60,000	0.60
\$ 0.60	100,000	3.98	60,000	0.60

Options granted vest over a period not exceeding five years. All stock options granted have an exercise price equal to the fair market value at the grant date.



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The Company has evaluated the fair value of all options granted during the past two years using the Black-Scholes option pricing model with the noted assumptions:

	<u>December 31, 2008</u> <u>Weighted Average</u>	December 31, 2007 <u>Weighted Average</u>
Estimated fair value at the date of grant for options granted in the period	<b>none granted</b>	\$0.32 - \$0.80
Assumptions utilized:		
Risk-free interest rate	n/a	4.25%
Expected volatility	n/a	70%
Expected life of the options	n/a	5 years
Expected Dividend Yield	n/a	3.5%

*(c) Contributed surplus*

The following is a continuity of the changes in contributed surplus for the year ended December 31, 2008. Contributed surplus is made up of stock based compensation expense and -\$369 for an allocation for common share buy back.

	<u>2008</u>	2007
Balance, beginning of year	\$ 40,489	\$ 174,261
Allocation to contributed surplus for common share buy back	(369)	-
Stock-based compensation expense (forfeited) during the year	26,747	(49,063)
Allocated to share capital on exercise of options during the year	(11,370)	(84,709)
Balance, end of year	\$ 55,497	\$ 40,489



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**11. EMPLOYEE FUTURE BENEFITS**

The changes in the benefit obligations and in the fair value of assets and the funded status of the defined benefit plans are as follows:

	Registered Pension Plans	
	2008	2007
Change in benefit obligations		
Projected benefit obligation, beginning of year	\$ 448,363	\$ 353,900
Current service cost	27,206	55,800
Interest cost	37,052	20,163
Actuarial (gains) losses	(40,095)	18,500
Projected benefit obligation, end of year	<b>472,526</b>	448,363
Change in fair value of plan assets		
Fair value of plan assets, beginning of year	336,975	237,168
Return on plan assets (deficiency)	(66,994)	2,108
Employer contributions	38,317	58,673
Employee contributions	-	39,026
Fair value of plan assets, end of year	<b>308,298</b>	336,975
Funded status (plan deficit)	(164,228)	(111,388)
Unamortized net actuarial (gain) loss	108,501	17,267
Unamortized past service costs	73,500	138,075
Unamortized transitional (asset) obligation	-	(25,638)
Valuation allowance	(17,773)	(18,316)
Accrued benefit asset (liability)	-	-

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The table below shows the net benefit plan cost before and after recognizing its long-term nature. The recognized net benefit plan cost reflects the amount reported in the Company's statement of income and is calculated according to the Company's accounting policy.

	Registered Pension Plans	
	2008	2007
Current service cost	\$ 27,206	\$ 55,800
Interest cost	37,052	20,163
Actual return on assets	(26,710)	(2,108)
Actuarial loss on accrued benefit obligation	-	-
Elements of employee future benefit plans cost, before recognizing its long-term nature	37,548	73,855
Actuarial loss	-	-
Difference between the actual return and estimated return on plan assets	-	-
Amortization of transitional asset (obligation)	(25,638)	(1,972)
Amortization of past service cost	14,700	12,553
Amortization of net actuarial loss	12,250	1,233
Others	-	-
Adjustment to recognize long-term nature of employee future benefit plans credit	1,312	11,814
Increase (decrease) in valuation allowance	(543)	12,030
Net benefit plans cost recognized	\$ 38,317	\$ 97,699

The net benefit cost is recorded as an operating expense in general and administration.

The significant actuarial assumptions adopted in measuring the Company's accrued benefit obligations are as follows:

	2008	2007
Discount rate	7.4%	5.6%
Expected long-term rate of return on plan assets	7.5%	7.5%
Rate of compensation increase	3.0%	3.0%

During the year the Company maintained two defined benefit pension plans that provide pension benefits for two key executives. The amounts reported in the financial statements relating to these



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benefits are determined using actuarial calculations that are based on several assumptions. One of the plans has been terminated and a wind up report as at March 31, 2008 has been filed and approved by the Financial Services Commission of Ontario. Thus there is a curtailment of this plan, since there is no further accrual of service, but not a settlement, as the funds have not yet been transferred out of the trust.

The Company's actuary performs a valuation at least every three years to determine the actuarial present value of the accrued pension and other retirement benefits. The valuation uses management's assumptions for the discount rate, expected long-term rate of return on plan assets, rate of compensation increase and expected average remaining years of service of employees. The last valuation was dated January 1, 2007.

While the Company believes that these assumptions are reasonable, differences in actual results or changes in assumptions could affect employee benefit obligations and future net benefit plans costs.

The Company accounts for differences between actual and assumed results by recognizing differences in benefit obligations and plan performance over the working lives of the employees who benefit from the plans. The two most significant assumptions used to calculate the net employee benefit plans cost are the discount rate and the expected long-term rate of return on plan assets.

*Discount Rate*

The discount rate is the interest rate used to determine the present value of the future cash flows that the Company expects will be needed to settle employee benefit obligations. It is based on the yield on long-term high-quality corporate fixed income investments, with maturities matching the estimated cash flows from the plan.

The Company determines the appropriate discount rate at the end of every year. The discount rate was 7.38% at December 31, 2008. A higher discount rate results in a lower accrued benefit obligation and unfunded liability.

*Expected Long-Term Rate of Return*

The expected long-term rate of return is a weighted average rate of our forward-looking view of long-term returns on each of the major plan asset categories in the pension funds.

The Company determines the appropriate expected long-term rate of return at the end of every year. An expected long-term rate of return on plan assets of 7.5% in 2008 was assumed, which is the same as it was in 2007. Although there is no immediate impact on the Company's balance



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sheet, poor fund performance results in a lower fair value of plan assets and a higher unfunded liability. This means that the Company may have to increase cash contributions to the plan in the future.

**12. EARNINGS PER SHARE**

The following table sets forth the computation of basic and diluted earnings per share:

	2008	2007
Net Income (loss)	\$ (1,335,554)	\$ 172,748
Weighted-average shares for earnings per share	13,377,610	12,874,497
Effect of dilutive securities Employee stock options	-	60,088
Adjusted weighted-average shares and assumed conversions for diluted earnings per share	13,377,610	12,934,585
Earnings (loss) per share	\$ (0.10)	\$ 0.01
Diluted (loss) earnings per share	\$ (0.10)	\$ 0.01

**13. FINANCIAL INSTRUMENTS AND FINANCIAL RISK MANAGEMENT**

(i) Risks – Overview

The Company's financial instruments and the nature of risks which they may be subject to are summarized as follows:

Financial instrument	Risks		
	Credit	Liquidity	Market risks Currency
<b>Measured at cost</b>			
Cash and cash equivalents	x		x
Accounts receivable	x		x
Accounts payable		x	
Obligations under capital lease		x	



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ii) Credit Risk

The following table summarizes the Company's exposure to credit risk.

	<b>December 31, 2008</b>	December 31, 2007
Cash and cash equivalents	<b>\$ 1,273,585</b>	\$ 2,882,305
Accounts receivable	<b>2,373,500</b>	2,875,202
	<b>\$ 3,647,085</b>	\$ 5,757,507

Cash and cash equivalents: Credit risk associated with cash and cash equivalents, which are held in short-term deposits, are minimized significantly by ensuring that these financial instruments are placed with major financial institutions with investment grade ratings and the avoidance of asset-backed commercial papers.

Accounts receivable: Credit risk associated with accounts receivable is minimized by the Company's large customer base and its geographic dispersion across Canada. The Company has credit evaluation, approval and monitoring processes intended to mitigate potential credit risks, and maintains provisions for potential credit losses that are assessed on an ongoing basis.

The following table presents an analysis of the age of accounts receivable as at the dates of the Consolidated Balance Sheets.

	<b>December 31, 2008</b>	December 31, 2007
Customer accounts receivable net of allowance for doubtful accounts		
Current	<b>1,646,066</b>	2,008,665
30-60 days past billing date	<b>663,581</b>	840,412
61-90 days past billing date	<b>41,304</b>	26,125
Greater than 90 days past billing date	<b>22,549</b>	-
	<b>2,373,500</b>	2,875,202

The Company must make significant estimates pertaining to allowance for doubtful accounts. Historical information, current economic conditions, exceptional circumstances are all considered when determining the provision for allowance for doubtful accounts. The following table presents a summary of the activity related to the Company's allowance for doubtful accounts for the twelve month period ending December 31, 2008.



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	2008	2007
Balance, beginning of period	74,648	13,899
Additions (provisions for doubtful accounts)	-	60,749
Deductions (provision written off to bad debts)	(74,648)	-
Balance, end of period	-	74,648

(iii) Liquidity Risk

The Company manages liquidity risk by continuously monitoring forecast and actual cash flows and working capital changes. The Company does not currently believe it will encounter difficulty in meeting its obligations associated with financial liabilities. The Company's undiscounted financial liability that shows the remaining contractual maturities are as follows:

As at December 31, 2008

	Capital lease
2009	19,443
2010	19,443
2011	14,581
	\$ 53,467

(iv) Currency Risk

The Company's functional currency is the Canadian dollar, but it regularly transacts in U.S. dollars for a portion of its business activities. The assets, liabilities, revenues and expenses denominated in U.S. dollars will be affected by changes in the exchange rate fluctuations in the market between the Canadian and U.S. dollar.

The Company makes use of foreign currency forward contracts and options contracts to fix the exchange rates on the U.S. dollar to mitigate its foreign exchange exposure on expenses. As at December 31, 2008 the Company did not possess foreign currency forward contracts and options contracts. However, the Company may make use of such contracts in the future.



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The net foreign exchange loss for 2008 was \$79,576 (2006 \$49,426) and has been recorded in general and administration expenses.

#### **14. CAPITAL MANAGEMENT**

The Company's objective in managing capital is to ensure sufficient liquidity to pursue its strategy of organic growth combined with strategic acquisitions, so that it can provide above-average returns for its shareholders. The Company defines capital that it manages as the aggregate of its shareholders' equity, which consists of issued capital, contributed surplus, accumulated other comprehensive income (loss) and retained earnings.

The Company manages its capital structure and makes adjustments to it in light of general economic conditions and the risk characteristics of the underlying assets and the Company's working capital requirements. In order to maintain or adjust the capital structure, the Company, upon approval from its Board of Directors, may issue long-term debt, issue shares, repurchase shares through a normal course issuer bid and pay dividends. The Board of Directors reviews and approves any material transactions not of the ordinary course of business which may include various acquisition proposals, as well as capital and operating budgets.

The Company monitors debt to equity ratios as part of the management of liquidity and return to shareholders under the following basis:

	Dec. 31, 2008	Dec. 31, 2007
Obligations under capital lease	28,921	47,185
Total long-term debt	28,921	47,185
Less: cash and cash equivalents	(1,273,585)	(2,882,305)
	(1,244,664)	(2,835,120)
Equity	2,954,561	4,246,640
Debt-to-equity ratio	0.01	0.01

The Company is not subject to externally imposed capital requirements.

#### **15. COMMITMENTS**



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*(i) Operating Leases*

The Company has operating leases for its switch facility and corporate office both of which expire on July 31, 2011. The future minimum payments under operating leases as at December 31, 2008 are as follows:

2009	197,997
2010	197,997
2011	165,673
	<hr/>
	\$ 561,667

*(ii) Capital Leases*

The future minimum payments under capital leases as at December 31, 2008 are as follows:

2009	19,443
2010	19,443
2011	14,581
	<hr/>
	\$ 53,467

**16. RELATED PARTY TRANSACTIONS**

- (i) The Company recovered overpayment's made to the Chairman from prior years, and a one-time \$12,000 salary adjustment in 2007. The balance was repaid through bi-weekly installments which commenced June 1, 2007 for the overpayment's, and December 1, 2007 for the salary adjustment. As of December 31, 2007, the outstanding balance receivable was \$76,489, which was included in Accounts Receivable. The full amount was repaid in fiscal 2008.
- (ii) Development costs totaling \$114,345 were expensed during 2007 to a company owned by an employee of the Company. The amount was recorded based on the exchange value and was included in development and technical expenses.

**17. CONTINGENT LIABILITIES**

- (i) The Company received a notice of claim from a vendor for marketing services it believes the Company was committed to pay. The amount of the claim against the



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Company is approximately \$230,000. The Company is vigorously defending such claims as it strongly believes it had never made such commitments. The outcome is not currently determinable. No amount has been recorded in the Consolidated Financial Statements in relation to this claim.

- (ii) From time to time the Company has been, and expects to continue to be, subject to legal proceedings and claims in the ordinary course of our business. Such claims, even if lacking merit, could result in the expenditure of significant financial and managerial resources. The Company is not aware of any legal proceedings or claims that it believes will have, individually or in the aggregate, a material adverse effect on the Company's financial condition or results of operation.
- (iii) The Company is in negotiations with a former executive involving a dispute that pertains to the terms of a settlement with the company dating back to 2004. The Company is pursuing to bring closure to this settlement with the former executive and has agreed to terms which are yet to be concluded by a written agreement. The Company has included in its financial statement the amount that has been agreed to between the parties.

**18. MATERIAL CONTRACT**

The Company executed a definitive employment agreement with the Company's President and CEO, the principal terms of which are a base salary of \$300,000 per annum, 19.5 months payment on termination without cause and 24 months upon a change of control. The Directors considered it in the best interests of all shareholders to confirm the definitive value of the President & CEO rights upon termination.

**19. COMPARATIVE FIGURES**

Certain comparative figures have been reclassified from statements previously presented to conform to the current presentation.

