

Consolidated Financial Statements

Lakeview Hotel Real Estate Investment Trust
December 31, 2010 and 2009

INDEPENDENT AUDITORS' REPORT

To the Unitholders of
Lakeview Hotel Real Estate Investment Trust

We have audited the accompanying consolidated balance sheets of **Lakeview Hotel Real Estate Investment Trust** [the "Trust"] as at December 31, 2010 and 2009, and the consolidated statements of loss and comprehensive loss, unitholders' equity and cash flows for the years then ended, and a summary of significant accounting policies and other explanatory information.

Management's responsibility for the consolidated financial statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with Canadian generally accepted accounting principles, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditors consider internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of **Lakeview Hotel Real Estate Investment Trust** as at December 31, 2010 and 2009 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Winnipeg, Canada,
April 29, 2011.

Ernst & Young LLP

Chartered Accountants

Lakeview Hotel Real Estate Investment Trust

CONSOLIDATED BALANCE SHEETS

[See note 1 regarding Going Concern Uncertainties]

As at December 31

	2010	2009
	\$	\$
ASSETS		
Current		
Cash	1,436,789	1,331,392
Reserve fund [note 2]	359,868	651,321
Cash held in trust [note 10]	2,510,108	2,500,000
Accounts receivable	1,486,356	1,075,291
Inventory	122,084	102,538
Prepaid expenses	190,632	157,864
Note receivable [note 3]	—	1,235,603
Total current assets	6,105,837	7,054,009
Franchise fees and licenses [note 4]	74,631	109,047
Income properties [notes 5, 7, 8, 10 and 14]	147,950,405	156,281,492
Investment in Lakeview Flag Licensing General Partnership [note 6]	263,217	265,193
	154,394,090	163,709,741
LIABILITIES AND UNITHOLDERS' EQUITY		
Current		
Accounts payable and accrued liabilities [note 14]	6,356,743	4,423,476
Loan payable [note 7]	4,200,000	4,200,000
Current portion of convertible debentures [note 9]	—	38,073
Current portion of mortgages payable [note 10]	78,150,466	78,430,822
Total current liabilities	88,707,209	87,092,371
Debentures [note 8]	9,907,313	9,703,065
Convertible debentures [note 9]	25,543,873	24,375,086
Mortgages payable [note 10]	4,827,666	7,025,786
Total liabilities	128,986,061	128,196,308
Unitholders' equity	25,408,029	35,513,433
	154,394,090	163,709,741

See accompanying notes

On behalf of the Board of Trustees:

"Gary Coleman"
Trustee

"Keith Levit"
Trustee

Lakeview Hotel Real Estate Investment Trust

CONSOLIDATED STATEMENTS OF LOSS AND COMPREHENSIVE LOSS

[See note 1 regarding Going Concern Uncertainties]

Years ended December 31

	2010	2009
	\$	\$
REVENUE		
Rooms	30,863,747	29,916,503
Food, beverage and gift shop	2,932,247	2,911,317
Income from Lakeview Flag Licensing General Partnership [note 6]	532,124	584,552
Interest and miscellaneous	933,954	1,089,164
	<u>35,262,072</u>	<u>34,501,536</u>
EXPENSES		
Amortization		
Franchise fees and licenses	34,416	57,141
Income properties	6,632,795	6,694,496
Food, beverage and gift shop	1,022,379	1,115,983
General and administration [note 14]	7,196,935	7,666,040
Insurance	364,341	341,749
Interest		
Loan and other	214,287	209,943
Mortgages and debentures	9,861,006	9,791,324
Maintenance	800,289	757,210
Marketing [note 14]	2,322,154	2,326,023
Property taxes	1,939,394	1,990,392
Provision for impairment of income properties [note 5]	2,000,000	—
Provision for impairment of note receivable [note 3]	1,396,062	—
Rent [note 19]	79,173	74,396
Salaries and benefits [note 14]	9,461,278	9,324,300
Supplies	755,214	721,409
Utilities	1,411,753	1,499,240
	<u>45,491,476</u>	<u>42,569,646</u>
Net loss and comprehensive loss for the year	<u>(10,229,404)</u>	<u>(8,068,110)</u>
Basic and diluted net loss and comprehensive loss per Unit [note 13]	<u>(0.523)</u>	<u>(0.414)</u>

See accompanying notes

Lakeview Hotel Real Estate Investment Trust

**CONSOLIDATED STATEMENTS OF
UNITHOLDERS' EQUITY**

[See note 1 regarding Going Concern Uncertainties]

Years ended December 31

	2010	2009
	\$	\$
Unitholders' capital <i>[note 11]</i>		
Balance, beginning of year	59,168,318	59,040,134
Repayment of convertible debentures by issuance of Units	—	128,184
Convertible debentures matured <i>[note 9[a]]</i>	11,566	—
Balance, end of year	<u>59,179,884</u>	<u>59,168,318</u>
Equity portion of convertible debentures		
Balance, beginning of year	3,734,171	3,760,355
Convertible debentures matured <i>[note 9[a]]</i>	(11,566)	—
Repayment of convertible debentures	—	(26,184)
Balance, end of year	<u>3,722,605</u>	<u>3,734,171</u>
Contributed capital		
Balance, beginning of year	401,745	401,745
Issuance of Unit options <i>[note 12]</i>	124,000	—
Balance, end of year	<u>525,745</u>	<u>401,745</u>
Accumulated income (loss) and comprehensive income (loss)		
Balance, beginning of year	(6,776,521)	1,291,589
Net loss and comprehensive loss for the year	(10,229,404)	(8,068,110)
Balance, end of year	<u>(17,005,925)</u>	<u>(6,776,521)</u>
Accumulated distributions		
Balance, beginning of year	(21,014,280)	(20,821,532)
Distributions declared <i>[note 11]</i>	—	(192,748)
Balance, end of year	<u>(21,014,280)</u>	<u>(21,014,280)</u>
Unitholders' equity, end of year	<u>25,408,029</u>	<u>35,513,433</u>

See accompanying notes

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CONSOLIDATED STATEMENTS OF CASH FLOWS

[See note 1 regarding Going Concern Uncertainties]

Years ended December 31

	2010	2009
	\$	\$
OPERATING ACTIVITIES		
Net loss for the year	(10,229,404)	(8,068,110)
Add (deduct) items not involving cash		
Amortization of income properties	6,632,795	6,694,496
Amortization of franchise fees and licenses	34,416	57,141
Provision for impairment of income properties [note 5]	2,000,000	—
Provision for impairment of note receivable [note 3]	1,396,062	—
Compensation costs of Unit options [note 12]	124,000	—
Income from Lakeview Flag Licensing General Partnership [note 6]	(532,124)	(584,552)
Accretion on debt component of convertible debentures [note 9]	1,170,714	1,038,698
Accretion of debentures [note 8]	204,248	183,814
Accretion of mortgages payable	254,688	222,905
Decretion of mortgages receivable	—	56,877
Loss on settlement of mortgages receivable [note 3]	—	98,244
Loss on disposal of income properties	46,483	—
	<u>1,101,878</u>	<u>(300,487)</u>
Net change in non-cash working capital balances related to operations	<u>1,590,774</u>	<u>1,722,218</u>
Cash provided by operating activities	<u>2,692,652</u>	<u>1,421,731</u>
INVESTING ACTIVITIES		
Additions to income properties	(348,191)	(1,122,248)
Collection of mortgages and note receivable [note 3]	—	3,666,153
Transaction costs on mortgages receivable	—	(4,110)
Distribution from Lakeview Flag Licensing General Partnership [note 6]	534,100	439,530
Cash provided by investing activities	<u>185,909</u>	<u>2,979,325</u>
FINANCING ACTIVITIES		
Unitholders' distributions		
Class A	—	(187,748)
Exchangeable Units	—	(5,000)
Proceeds from mortgages payable	—	5,500,000
Repayment of mortgages payable	(2,733,164)	(7,432,409)
Repayment of convertible debentures [note 9[a]]	(40,000)	—
Financing costs on mortgages payable	—	(196,172)
Cash held in trust	—	(2,500,000)
Cash used in financing activities	<u>(2,773,164)</u>	<u>(4,821,329)</u>
Net increase (decrease) in cash during the year	105,397	(420,273)
Cash, beginning of year	<u>1,331,392</u>	<u>1,751,665</u>
Cash, end of year	<u>1,436,789</u>	<u>1,331,392</u>
Supplemental cash flow information		
Interest paid	<u>8,456,542</u>	<u>8,565,514</u>

See accompanying notes

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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1. GOING CONCERN, ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

Going concern

These consolidated financial statements have been prepared on a going concern basis in accordance with Canadian generally accepted accounting principles ["GAAP"] which contemplates that Lakeview Hotel Real Estate Investment Trust ["Lakeview Hotel REIT"] will continue in operations and be able to realize its assets and discharge its liabilities and commitments in the normal course of business for the foreseeable future.

As discussed in note 10, Lakeview Hotel REIT was not in compliance with the Fixed Charge Coverage Ratio ["FCCR"] requirement for a number of hotels pledged as security under its long-term mortgage agreements with its primary mortgage lender. Although it entered into a loan commitment agreement subsequent to December 31, 2010 with its primary mortgage lender to refinance the mortgages maturing in 2011 [note 10] and to refinance \$2,200,000 of the demand loan payable [note 7] and the agreement included a commitment to enter into a forbearance agreement with respect to the lender's right to demand repayment of the mortgages as a result of the non-compliance with the FCCR requirement as at December 31, 2010, there remains uncertainties relating to Lakeview Hotel REIT's ability to fulfill its commitments under the agreement with respect to the refinancing in 2011 with alternate lender(s) of two of three income properties that have current mortgages with maturity dates in 2012. As all long-term mortgage agreements with the primary mortgage lender are cross-collateralized, the entire balance of the long-term mortgages with the primary lender may be in default by December 31, 2011 and will be deemed as payable on demand. Therefore, these mortgages remain classified as current liabilities at December 31, 2010.

Included in current liabilities at December 31, 2010 and 2009 is a \$4,200,000 demand loan [note 7] and \$75,914,044 [2009 - \$78,210,359] of mortgages payable [note 10] to Lakeview Hotel REIT's primary mortgage lender. In addition, a \$2,000,000 second mortgage on the Days Inn - Ottawa Airport matures on August 1, 2011 [note 10]. Due to the items included in current liabilities, Lakeview Hotel REIT had a working capital deficiency of \$82,601,372 at December 31, 2010 [2009 - \$80,038,362]. Currently, management is in the process of arranging for the refinancing of the two of three income properties as committed to in the loan commitment agreement discussed above and for the refinancing of the Days Inn - Ottawa Airport second mortgage.

There is doubt about the appropriateness of the going concern assumption because of the uncertainty caused by the current market conditions and possible default on Lakeview Hotel REIT's mortgages with the primary mortgage lender should Lakeview Hotel REIT not be able to

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fulfill its commitments under the loan commitment agreement as discussed above. Lakeview Hotel REIT experienced declines in room revenue in 2009 which continued into 2010, reflecting a weak economic environment and a marked slowdown in the oil and gas industry in the vicinity of several of Lakeview Hotel REIT's properties. Although there are signs of recovery, as reflected by the increase in revenue and cash flow from operations in 2010, the cash flow of Lakeview Hotel REIT remains constrained. The cash flow constraints and the outcome of the refinancing efforts result in uncertainty as to whether Lakeview Hotel REIT will be able to meet its financial obligations as they become due.

Management continues to employ various strategies to improve operating results and cash flows and to assess strategies to adjust its capital structure. This includes implementation of marketing initiatives aimed toward maximizing revenues, various cost reduction measures and seeking out alternative sources of debt or equity. While management believes that progress is being made in the implementation of these strategies and refinancing can be arranged for the mortgages required under the agreement with the primary lender and the second mortgage maturing in 2011, there is no assurance as to their outcome or success. Further, Lakeview Hotel REIT's results for future periods are subject to uncertainties arising from the pace of recovery of the economy and from fluctuations in oil and gas prices.

Lakeview Hotel REIT's ability to continue as a going concern is also subject to the continued support of related parties [note 14]. Specifically, Lakeview Hotel REIT has deferred payment of certain marketing, accounting, reservation, licensing and management fees to related parties.

The consolidated financial statements do not reflect adjustments that would be necessary if the going concern assumption were not appropriate. If the going concern basis was not appropriate for these consolidated financial statements, then adjustments would be necessary to the carrying value of assets and liabilities, the reported revenue and expenses and the balance sheet classifications used. These adjustments may be material.

Organization and basis of presentation

Lakeview Hotel REIT is a closed-end real estate investment trust that was created pursuant to the Declaration of Trust dated February 11, 2004. Lakeview Hotel REIT was established under the laws of the Province of Manitoba and the laws of Canada applicable therein. Lakeview Hotel REIT issued Trust Units pursuant to a Qualifying Transaction, including a Plan of Arrangement which was completed on April 15, 2004. The Qualifying Transaction consisted of a private offering of Lakeview Hotel REIT Units, a public offering of Lakeview Hotel REIT subordinated convertible debentures, the acquisition of the Lakeview Inn & Suites, Fredericton, New Brunswick and the acquisition of a 49% interest in the Lakeview Flag Licensing General Partnership and a 50% interest in the Lakeview Flag Management General Partnership as described below. The principal purpose of Lakeview Hotel REIT is to provide Unitholders with an opportunity to

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participate in a diversified portfolio of hotel and extended-stay properties, and commercial and office properties ancillary thereto, located throughout Canada and the United States.

These consolidated financial statements include the accounts of Lakeview Hotel REIT's subsidiaries as follows: Lakeview Hotel REIT Operating Trust, Lakeview Flag Operating LP General Partner Inc., Lakeview Flag Operating Limited Partnership, 2330407 Manitoba Ltd., 1164656 Alberta Ltd., 1184720 Alberta Ltd., 1208406 Alberta Ltd., 1208417 Alberta Ltd., Vaughan Steeles Super 8 Ltd., 1227671 Alberta Ltd., 1236406 Alberta Ltd., 1236412 Alberta Ltd., 0759566 B.C. Ltd., 0760018 B.C. Ltd., 0760024 B.C. Ltd., 1312258 Alberta Ltd., 1317639 Alberta Ltd., 1323785 Alberta Ltd., 1360841 Alberta Ltd., 0816064 B.C. Ltd., 2178222 Ontario Inc., 1368641 Alberta Ltd., 0817928 B.C. Ltd. and 0824414 B.C. Ltd. Transactions within the consolidated group are eliminated upon consolidation.

The 50% interest in the Lakeview Flag Management General Partnership is proportionately consolidated as the partners jointly control this partnership. The 49% interest in the Lakeview Flag Licensing General Partnership is accounted for using the equity method.

Significant accounting policies

Inventory

Inventory is recorded at the lower of cost, on a first-in, first-out basis, and net realizable value.

Franchise fees and licenses

Franchise fees include the application and initial fees associated with the transfer of membership of hotel franchises to Lakeview Hotel REIT. Franchise fees are stated at cost less accumulated amortization. Amortization is recorded using the straight-line method over the shorter of the term of the franchise agreement and the period over which management estimates the franchise will be retained.

Licenses include the costs associated with the purchase of the right to continue operation of existing video lottery terminals. Licenses are stated at cost less accumulated amortization. Amortization is recorded using the straight-line method over five years.

Income properties

Income properties include land, buildings, parking lots, signs, furniture, fixtures and equipment and automobiles.

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Income properties are stated at the lower of cost, less accumulated amortization, and estimated net recoverable amount. Long-lived assets are reviewed at the individual hotel level, the lowest level for which identifiable cash flows are largely independent, when testing for and measuring impairment. Income properties are tested for recoverability when events or changes in circumstances indicate that their carrying value may not be recoverable. A two-step process is used to assess the impairment of long-lived assets held for use, with the first step determining when impairment is recognized and the second step measuring the amount of the impairment. Impairment losses are recognized when the carrying amount of long-lived assets exceeds the sum of the undiscounted cash flows expected to result from their use and eventual disposition and are measured as the amount by which the long-lived asset's carrying amount exceeds its fair value.

Maintenance and repair costs are expensed against operations as incurred, while significant improvements, replacements and major renovations over \$30,000 are capitalized to income properties.

Amortization is recorded on a straight-line basis as follows:

Buildings	30 - 40 years
Parking lots	10 years
Signs	10 years
Furniture, fixtures and equipment	3 - 10 years
Automobiles	5 years

Revenue recognition

Room revenue is recognized when the services are performed and collection is reasonably assured, which is generally on the night the rooms are rented.

Food and beverage revenue is recognized when the services are performed.

Interest income is recognized on an accrual basis using the effective interest method.

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Related parties

During 2010 and 2009, Lakeview Hotel REIT had transactions with the following related parties:

<u>Related parties</u>	<u>Nature of relationship</u>
Lakeview Management Inc. ["LMI"]	Unitholder and administrator
Free to Guest Movies Ltd.	A company related to LMI
Lakeview Flag Licensing General Partnership	Equity investee
Lakeview Flag Management General Partnership	Joint venture investee
XYZ Design Inc.	A company related to LMI
Keith Levit Photography	A business owned by the President and Trustee

Lakeview Perks Loyalty Program

In 2006, LMI introduced the Lakeview Perks Loyalty Program. Members of the Lakeview Perks Loyalty Program earn points based on their spending at Lakeview Inn & Suites hotels and Lakeview Resorts. Points can be redeemed for hotel stays at participating hotels or for other services or merchandise. The future redemption liability is included in accounts payable and accrued liabilities and is estimated based on points awarded and management's assessment of anticipated point redemptions and point value.

Management adjusts the estimated liability based on redemption experience and additional points awarded and such adjustments are recorded in the results of operations.

Income taxes

In June 2007, the Government of Canada enacted new legislation imposing additional income taxes upon publicly traded income trusts classified as Specified Investment Flow-Throughs ["SIFT"], which include a real estate investment trust ["REIT"] that carries on Canadian hotel operations effective January 1, 2011. Prior to June 2007, Lakeview Hotel REIT estimated the future income tax on certain temporary differences between amounts recorded on its balance sheet for book and tax purposes at a nil effective tax rate. Under the legislation, Lakeview Hotel REIT now estimates the effective tax rate on the post-2010 reversal of these temporary differences to be 27%. Temporary differences reversing before 2011 will still give rise to nil future income taxes. The effect of changes in income tax rates on future income tax assets and liabilities is recognized in the period in which the change occurs. Valuation allowances are recorded unless it is more likely than not that a future income tax asset will be realized.

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The amount and timing of reversals of temporary differences will also depend on Lakeview Hotel REIT's future operating results, acquisitions and dispositions of assets and liabilities and distribution policy. A significant change in any of the preceding assumptions could materially affect Lakeview Hotel REIT's estimate of the future income tax assets and liabilities.

Net loss and comprehensive loss per Unit

Basic net loss and comprehensive loss per Unit is based on the consolidated net loss for the year divided by the weighted average number of Units outstanding during the year. Diluted net loss and comprehensive loss per Unit is computed in accordance with the treasury stock method and based on the weighted average number of Units and dilutive unit equivalents.

Stock-based compensation plan

Lakeview Hotel REIT has a Unit Purchase Plan as described in note 12. The fair value method is used to determine the expense for stock-based awards granted to employees and non-employees. Under the fair value method, compensation cost is measured at fair value at the date of grant using the Black-Scholes option pricing model. The compensation expense is expensed over the vesting period with a corresponding credit to contributed surplus. Consideration paid on the exercise of Unit options plus the amount of previously recognized expense is credited to unitholders' capital when the options are exercised.

Use of estimates

The preparation of financial statements in accordance with Canadian GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingencies at the date of the consolidated financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from these estimates.

Financial instruments

Lakeview Hotel REIT has the following financial assets and liabilities:

- Cash, reserve fund and cash held in trust are classified as "assets held-for-trading" and are measured at fair value. Gains and losses resulting from the periodic revaluation are recorded in net loss.

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- Accounts receivable are classified as "loans and receivables" and are recorded at cost, which upon their initial measurement is equal to their fair value. Subsequent measurements are recorded at amortized cost using the effective interest method.
- Accounts payable and accrued liabilities, loan payable, debentures, convertible debentures and mortgages payable are classified as "other financial liabilities" and are initially measured at their fair value. Subsequent measurements are recorded at amortized cost using the effective interest method. Under the effective interest method, financing costs must be applied against the debt to which they relate. Over the term of the debt the long-term liability will increase to the face value of the debt with the accretion being included in interest on mortgages and debentures on the consolidated statements of loss and comprehensive loss.

Future accounting changes

International Financial Reporting Standards ["IFRS"]

The Canadian Accounting Standards Board ["AcSB"] confirmed that the adoption of IFRS will be effective for the interim and annual periods beginning on or after January 1, 2011 for Canadian publicly accountable profit-oriented enterprises, with appropriate comparative data from the prior year. These standards will be effective for Lakeview Hotel REIT in the first quarter of 2011. The consolidated financial performance and financial position as disclosed in Lakeview Hotel REIT's current GAAP consolidated financial statements will be significantly different when presented in accordance with IFRS.

2. RESERVE FUND

Pursuant to the Hotel Management Agreements with Lakeview Flag Management General Partnership, the Lakeview Hotel REIT's properties are required to reserve funds in a separate account for ongoing capital repairs, replacements and/or improvements of the property including, but not limited to, the regular repair, replacement and maintenance of the furniture, fixtures and equipment. Under the terms of the Hotel Management Agreements, the properties are required to make monthly deposits into the reserve fund account equal to not less than 2% of monthly gross revenue.

	2010	2009
	\$	\$
Reserve fund, beginning of year	651,321	545,824
Allocations to reserve fund	770,056	774,515
Use of reserve fund	(1,061,509)	(669,018)
Reserve fund, end of year	359,868	651,321

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Under approval by the Trustees, included in the use of reserve fund during 2010 were amounts withdrawn to fund operations.

3. MORTGAGES AND NOTE RECEIVABLE

During 2008, Lakeview Hotel REIT had advanced amounts under a mezzanine loan arrangement with an independent hotel developer and its related parties for the development of three hotels in British Columbia and Alberta. The amounts were registered as mortgages and classified as mortgages receivable. The mortgages receivable earned interest at 12% per annum compounded and payable monthly. Payments of interest only were received on the mortgages. The principal was due no later than the maturity of the mortgages, which was on the third anniversary of the date upon which the last advance under the loan was made. Lakeview Hotel REIT made its final advance of \$1,000,000 for a total advance of \$5,000,000 on August 1, 2008. During 2009, \$3,628,882 was collected on the mortgages receivable and a further \$98,244 was forgiven on settlement as described below.

During 2009, all mortgage charges were discharged and a promissory note was taken back for the balance owing of \$1,272,874. The note receivable bears interest at 12% per annum and was to be repaid by blended monthly payments of \$50,000 from August 31, 2009 to June 30, 2010, and a final payment of \$841,764 on July 31, 2010. On August 31, 2009, a further \$37,271 was collected on the note receivable, leaving an outstanding balance at December 31, 2010 of \$1,235,603. The interest receivable balance that had accrued to September 30, 2010 and is outstanding at December 31, 2010 is \$160,459. The borrowers have been in default of their monthly payments since September 2009.

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The carrying value of the note receivable balance represented Lakeview Hotel REIT's maximum exposure to related credit risk without taking into account any collateral held or any other credit enhancements. The note receivable is collateralized by a transfer of land located at Tumbler Ridge, British Columbia owned by the borrowers, second and/or third charges against other lands owned by the borrowers and corporate and personal guarantees from the borrowers. In August 2010, Lakeview Hotel REIT was informed that a receiver-manager was appointed over the assets on the Tumbler Ridge land by way of a joint appointment made by holders of the first mortgage security on the Tumbler Ridge assets. Subsequently, Lakeview Hotel REIT learned that the Tumbler Ridge property was listed for sale. Management believes there are significant uncertainties as to the final proceeds once a sale is actually concluded. Therefore, after payment to the holders of the first mortgage security, it is uncertain as to whether Lakeview Hotel REIT will be able to recover any of the note receivable or interest receivable outstanding at December 31, 2010 from the proceeds of the sale of the Tumbler Ridge property or from any of the other collateral. Accordingly, during 2010, Lakeview Hotel REIT recorded a provision for impairment of note receivable for the entire \$1,235,603 note receivable outstanding at December 31, 2010 and \$160,459 of interest receivable that had accrued to September 30, 2010.

During 2010 and 2009, interest income recognized on the mortgage receivable was nil [2009 - \$306,038] and on the note receivable was \$110,900 [2009 - \$68,565]. No further interest was accrued on the note receivable subsequent to September 30, 2010.

4. FRANCHISE FEES AND LICENSES

	2010	2009
	\$	\$
Cost	196,632	206,632
Less accumulated amortization	(122,001)	(97,585)
	74,631	109,047

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5. INCOME PROPERTIES

	2010			2009		
	Cost \$	Accumulated amortization \$	Net book value \$	Cost \$	Accumulated amortization \$	Net book value \$
Land	15,314,719	—	15,314,719	15,493,719	—	15,493,719
Buildings	143,039,590	14,680,927	128,358,663	144,768,287	11,064,380	133,703,907
Parking lots	715,710	214,051	501,659	715,710	142,480	573,230
Signs	541,328	187,649	353,679	534,138	134,056	400,082
Furniture, fixtures and equipment	15,295,570	11,896,817	3,398,753	15,124,523	9,013,969	6,110,554
Automobile	26,460	3,528	22,932	—	—	—
	174,933,377	26,982,972	147,950,405	176,636,377	20,354,885	156,281,492

As a result of the current market conditions and decline in room revenues as discussed in note 1, management assessed the potential impairment of income properties on an individual hotel basis. Impairment is recognized when the carrying value of the hotel's assets exceed the total undiscounted cash flows expected from its use and eventual disposition.

As a result of the annual impairment test performed as at December 31, 2010, it was determined that an impairment loss should be recognized and is measured as the amount by which the carrying amount of the income properties exceed their fair values. Fair values are estimated based on discounted cash flow projections and available market information. Cash flow projections incorporate assumptions that marketplace participants would use in their estimates and Lakeview Hotel REIT's own assumptions. Accordingly, Lakeview Hotel REIT recorded an impairment loss on income properties of \$2,000,000 in 2010. No impairment provision was recorded in 2009 as a result of the annual impairment test as at December 31, 2009.

Actual results will differ from the forecast estimates and assumptions and the differences may be significant. The future long-term cash flows forecast is also dependent on the going concern assumptions as discussed in note 1. Should Lakeview Hotel REIT not be able to continue on a going concern basis, the liquidation value of the income properties will be significantly different from the carrying value.

Lakeview Hotel Real Estate Investment Trust

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6. INVESTMENT IN LAKEVIEW FLAG LICENSING GENERAL PARTNERSHIP

On April 15, 2004, Lakeview Hotel REIT indirectly acquired a 49% interest in Lakeview Flag Licensing General Partnership with nominal initial capitalization of \$49 and issuance of the Lakeview Flag Operating Limited Partnership Class E Units [exchangeable into 500,000 Units, the "Exchangeable Units"], 500,000 Class V Special Trust Units and 1 Class T Special Trust Unit of Lakeview Hotel REIT. The principal purpose of the Lakeview Flag Licensing General Partnership is to hold the trademarks, trade names, operating procedures, systems, related items and goodwill associated therewith of the hotel flags known as "Lakeview Inn & Suites" and "Lakeview Resorts" ["Lakeview Flag"]. Although the exchange amount was \$1,000,000, the transaction was recorded at the carrying value of \$1 in accordance with Canadian GAAP applicable to related party transactions because the 49% interest in Lakeview Flag Licensing General Partnership was acquired from a company controlled by certain Unitholders of Lakeview Hotel REIT and the exchange amount was not supported by independent evidence.

Lakeview Flag Licensing General Partnership earns income, pursuant to the Sub-franchise Agreement and the License Agreements with the respective hotels, through the payment to it of a license fee equal to 4% of gross room revenue received from the following Lakeview Inn & Suites hotels which are owned by LMI and located as follows:

Bathurst, New Brunswick [Canada]
Brandon, Manitoba [Canada]
Grand Forks, North Dakota [United States of America]
Halifax, Nova Scotia [Canada]
Miramichi, New Brunswick [Canada]

In addition, pursuant to the Sub-franchise Agreement and the License Agreements, Lakeview Flag Licensing General Partnership earns a license fee of 4% of gross room revenue from each Lakeview Hotel REIT property that has opened as or has been converted to a Lakeview Inn & Suites hotel or Lakeview Signature Inn. The license fees are earned effective as of the date of opening or conversion.

The Lakeview Flag Licensing General Partnership also earned a license fee of 4% of gross room revenue from the Lakeview Inn & Suites - Tumbler Ridge [located in British Columbia] for the period September 1, 2008 to June 30, 2009, the Lakeview Inn & Suites - Hudson's Hope [also located in British Columbia] for the period September 17, 2008 to July 15, 2009 and the Lakeview Inn & Suites - Fox Creek [located in Alberta] for the period November 4, 2008 to June 30, 2009 [note 3].

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Gross room revenue is the gross income resulting from all room sales made to customers or guests of the respective hotels and does not include any sales tax which is collected and remitted to the appropriate tax authority by the hotels.

Investment in Lakeview Flag Licensing General Partnership consists of the following:

	2010 \$	2009 \$
Investment, beginning of year	265,193	120,171
Equity income	532,124	584,552
Distribution received	(534,100)	(439,530)
Investment, end of year	263,217	265,193

7. LOAN PAYABLE

	2010 \$	2009 \$
Loan payable	4,200,000	4,200,000

The loan payable was drawn under a pre-approved line of credit facility provided by Lakeview Hotel REIT's primary mortgage lender. The loan payable bears interest at the Canadian bankers' acceptance rate plus 4.25% to 5% floating rate per annum, due on demand, collateralized by first mortgages on certain income properties. The effective interest rate was 5.10% in 2010 [2009 - 4.98%].

Subsequent to year end, Lakeview Hotel REIT entered into a loan commitment agreement to refinance \$2,200,000 of the loan payable with mortgages [note 10].

8. DEBENTURES

Effective March 28, 2008, Lakeview Hotel REIT, through a public offering, issued \$10,250,000 Series A Senior Secured Debentures [the "Debentures"]. The Debentures mature on June 20, 2012 and bear interest at an annual rate of 8.125% payable monthly in cash. The Debentures are secured by a first charge on the Four Points by Sheraton - Prince George hotel, an assignment of the insurance policy on the property, an assignment of rents and leases of the property and an assignment of material contracts and agreements. The Debentures are redeemable in full from time to time at Lakeview Hotel REIT's sole option on not less than 30 days' prior written notice, at

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a price equal to 110% of the principal amount plus accrued and unpaid interest up to, but excluding, the date of redemption.

	2010 \$	2009 \$
Principal	10,250,000	10,250,000
Financing costs	(855,121)	(855,121)
Accretion of debentures	512,434	308,186
	<u>9,907,313</u>	<u>9,703,065</u>

The accretion of debentures of \$204,248 [2009 - \$183,814] is included in interest expense.

9. CONVERTIBLE DEBENTURES

At initial measurement, the convertible debentures were allocated to debt and equity components based on the estimated cost of borrowing without the conversion option as follows:

	Debt \$	Equity \$	Total \$
9% Subordinated Convertible Debentures	1,066,282	433,718	1,500,000
6.5% Series C Convertible Redeemable Subordinated Debentures	14,937,187	3,062,813	18,000,000
8.5% Series D Convertible Redeemable Subordinated Debentures	9,045,732	954,268	10,000,000
	<u>25,049,201</u>	<u>4,450,799</u>	<u>29,500,000</u>

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The details of the series of convertible debentures are outlined in the tables below:

Debentures	2010			
	Effective interest rate %	Original face amount \$	Converted to Units \$	Face amount outstanding \$
6.5% Series C Convertible Redeemable Subordinated Debentures	11%	18,000,000	—	18,000,000
8.5% Series D Convertible Redeemable Subordinated Debentures	11%	10,000,000	20,000	9,980,000
		28,000,000	20,000	27,980,000

Debentures	2010				
	Face amount outstanding \$	Holder's conversion option \$	Accretion \$	Financing costs \$	Carrying values \$
Long-term					
6.5% Series C Convertible Redeemable Subordinated Debentures	18,000,000	(3,062,813)	2,611,948	(1,058,428)	16,490,707
8.5% Series D Convertible Redeemable Subordinated Debentures	9,980,000	(952,360)	741,593	(716,067)	9,053,166
	27,980,000	(4,015,173)	3,353,541	(1,774,495)	25,543,873

Debentures	2009			
	Effective interest rate %	Original face amount \$	Converted to Units \$	Face amount outstanding \$
9% Subordinated Convertible Debentures	18%	1,500,000	1,460,000	40,000
6.5% Series C Convertible Redeemable Subordinated Debentures	11%	18,000,000	—	18,000,000
8.5% Series D Convertible Redeemable Subordinated Debentures	11%	10,000,000	20,000	9,980,000
		29,500,000	1,480,000	28,020,000

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Debtures	2009				
	Face amount outstanding \$	Holder's conversion option \$	Accretion \$	Financing costs \$	Carrying values \$
Current					
9% Subordinated Convertible Debentures	40,000	(11,566)	13,249	(3,610)	38,073
Long-term					
6.5% Series C Convertible Redeemable Subordinated Debentures	18,000,000	(3,062,813)	1,751,213	(1,058,428)	15,629,972
8.5% Series D Convertible Redeemable Subordinated Debentures	9,980,000	(952,360)	433,541	(716,067)	8,745,114
	<u>27,980,000</u>	<u>(4,015,173)</u>	<u>2,184,754</u>	<u>(1,774,495)</u>	<u>24,375,086</u>
	<u>28,020,000</u>	<u>(4,026,739)</u>	<u>2,198,003</u>	<u>(1,778,105)</u>	<u>24,413,159</u>

The accretion of the debt component, which increases the debt component from the initial carrying amount, is included in interest expense and totalled \$1,170,714 in 2010 [2009 - \$1,038,698].

[a] 9% Subordinated Convertible Debentures

On May 30, 2005, under a private offering, Lakeview Hotel REIT issued \$1,500,000 of the 9% Subordinated Convertible Debentures.

At maturity, on May 30, 2010, the remaining \$40,000 in face value outstanding of the 9% Subordinated Convertible Debentures were repaid in full with cash. The related equity portion of the convertible debentures of \$11,566 was transferred to unitholders' capital.

[b] 6.5% Series C Convertible Redeemable Subordinated Debentures

On June 20, 2007, under a public offering, Lakeview Hotel REIT issued \$18,000,000 of the 6.5% Series C Convertible Redeemable Subordinated Debentures.

The debentures bear interest at 6.5%, mature June 30, 2012 and are subordinate only to property specific conventional mortgage financing and any vendor take-back mortgage financing. The debentures are convertible by the holder at any time after the date of issue at \$5.55 per Unit.

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At any time after three years from the issue date but prior to four years from the issue date, Lakeview Hotel REIT has the right to redeem all, but not less than all, debentures at par plus accrued interest provided that the volume-weighted average trading price of the Units during a 20 consecutive trading day period ending five trading days before notice of redemption is given is not less than 125% of the conversion price. On maturity, the debentures are repayable at par plus any accrued and unpaid interest in cash, or at the option of Lakeview Hotel REIT, in Units [based on a Unit conversion price equal to 95% of the weighted average of the trading price of the Units during the preceding 20 consecutive trading day period], or in any other combination thereof.

[c] 8.5% Series D Convertible Redeemable Subordinated Debentures

On May 8, 2008, under a public offering, Lakeview Hotel REIT issued \$10,000,000 of the 8.5% Series D Convertible Redeemable Subordinated Debentures.

The debentures bear interest at 8.5%, mature May 31, 2013 and are subordinate only to property specific conventional mortgage financing, any vendor take-back mortgage financing and the Series A Senior Secured Debentures issued March 28, 2008 [note 8]. The debentures are convertible by the holder at any time prior to maturity at \$3.75 per Unit.

The debentures will not be redeemable prior to May 31, 2011. On and after May 31, 2011, but prior to May 31, 2012, the debentures will be redeemable, in whole or in part from time to time at Lakeview Hotel REIT's sole option on not more than 60 days and not less than 30 days' notice at a price payable in cash, equal to the principal amount plus accrued and unpaid interest, provided that the volume-weighted average trading price of the Units on the TSXV during the 20 consecutive trading days ending on the fifth trading day preceding the date on which notice of redemption is given is not less than 150% of the conversion price.

On and after May 31, 2012, but prior to the Maturity Date, the debentures will be redeemable in whole or in part from time to time at Lakeview Hotel REIT's sole option on not more than 60 days and not less than 30 days' notice at a price payable in cash, equal to the principal amount thereof, plus accrued and unpaid interest, provided that the current market price is not less than 125% of the conversion price.

On maturity, the debentures are repayable at par plus any accrued and unpaid interest in cash.

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10. MORTGAGES PAYABLE

	2010 \$	2009 \$
[a] Mortgages payable, bearing interest at 5.88% to 6.74% per annum, due February 1, 2011 to July 1, 2014, collateralized by first charges on certain income properties, an assignment of the insurance policy on the income properties, an assignment of rents and leases of the income properties and an assignment of material contracts and agreements. The mortgages are cross-collateralized by each of the underlying properties with the exception of the Four Points by Sheraton - Prince George hotel [note 8] and the Days Inn - Ottawa Airport	75,914,044	78,210,359
[b] Mortgage payable, bearing interest at 7% per annum, due August 21, 2014, collateralized by a first charge on the Days Inn - Ottawa Airport, an assignment of the insurance policy on the income property, an assignment of rents and leases of the income property and a guarantee from Lakeview Hotel REIT	5,064,088	5,246,249
[c] Mortgage payable, bearing interest at 9.5% per annum, due August 1, 2011, collateralized by a second ranking charge on the Days Inn - Ottawa Airport and an assignment of the insurance policy on the income property second behind the first mortgage holder. Payments of interest only are due on the mortgage	2,000,000	2,000,000
	82,978,132	85,456,608
Less current portion	78,150,466	78,430,822
	4,827,666	7,025,786

The agreements for the mortgages in [a] contain financial covenants that require each individual hotel property, pledged as security for these mortgages, to maintain a minimum 1.30 Fixed Charge Coverage Ratio ["FCCR"], calculated on an annual basis, as defined in the mortgage agreements. As at December 31, 2008, Lakeview Hotel REIT was not in compliance with the FCCR requirement for six of the hotel properties. In 2009, Lakeview Hotel REIT obtained an agreement from its lender to forbear its rights and remedies as a result of the FCCR covenant breach at December 31, 2008. As per the conditions of the lender's agreement, two letters of credit of \$1,250,000 each were provided by LMI in favor of the mortgage lender to draw upon in the event of default. In November 2009, Lakeview Hotel REIT entered into an "Escrow Agreement" with the lender whereby it transferred \$2,500,000 to be held in trust with an escrow agent in favor of the lender. This cash collateral replaced the two letters of credit provided by LMI. Interest earned on the cash held in trust to December 31, 2010 was \$10,108.

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As at December 31, 2009, Lakeview Hotel REIT was not in compliance with the FCCR requirement for 11 of the hotel properties. Since the mortgages were cross-collateralized by each of the underlying properties, repayment of the mortgages in [a] could have been demanded at any time in 2010. Accordingly, the mortgages were all classified as current liabilities as at December 31, 2009.

As at December 31, 2010, Lakeview Hotel REIT was not in compliance with the FCCR requirement for 10 of the hotel properties. However, subsequent to year end, Lakeview Hotel REIT entered into a loan commitment agreement with the mortgage lender to refinance the seven mortgages maturing from February 1, 2011 to July 1, 2011 [with total carrying values of \$27,501,018 as at December 31, 2010] and \$2,200,000 of the loan payable [note 7]. As part of the loan commitment agreement, the lender has agreed to enter into a forbearance agreement regarding its right to demand repayment of all of the mortgages as a result of the non-compliance of the FCCR requirement at December 31, 2010. The refinanced mortgages will have a three year term with annual fixed interest rates at 4.35% above the three-year Canadian dollar fixed interest SWAP rate. Total loan fees of 1% of the loan amount are due on September 1, 2011. Also as part of the loan commitment agreement, Lakeview Hotel REIT is committed to obtain refinancing from alternate mortgage lender(s) for one income property with a mortgage maturing January 1, 2012, and for another one of two income properties with mortgages maturing on May 1, 2012 and December 1, 2012, respectively. If Lakeview Hotel REIT has not received refinancing for these two income properties by September 1, 2011 and the related mortgages are not repaid by December 31, 2011, this will be considered an event of default and repayment of all of the mortgages can be demanded at any time. As a result of this contingency and the possibility that a number of the hotels will not be in compliance with the FCCR requirement at December 31, 2011, as well as the cross-collateralization of all the mortgages in [a], these mortgages have all been classified as current liabilities as at December 31, 2010.

The agreement for the mortgage payable in [b] contains a cross-default provision with Lakeview Hotel REIT's other debt obligations. Therefore, as a result of the non-compliance with the financial covenants for the mortgages noted above, Lakeview Hotel REIT was also not in compliance with this mortgage agreement as at December 31, 2010 nor 2009. However, during 2010, Lakeview Hotel REIT obtained an agreement from the lender to waive its right to demand repayment of the mortgage as a result of the covenant breach as at December 31, 2009. In addition, subsequent to year end, Lakeview Hotel REIT obtained another agreement from the lender to waive its right to demand repayment of the mortgage as a result of the covenant breach at December 31, 2010. Accordingly, the portion of the mortgage in [b] not due within the next year continues to be classified as a long-term liability as it was at December 31, 2009.

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Estimated future principal repayments over the next four years, based on the repayment schedules of the mortgages and assuming repayment is not demanded before the mortgage maturity dates, are as follows:

	\$
2011	31,323,895
2012	30,713,315
2013	5,014,634
2014	16,342,564
Total principal outstanding	83,394,408
Financing costs	(1,293,414)
Accretion of mortgages	877,138
	<u>82,978,132</u>

11. UNITHOLDERS' CAPITAL

	Class A Units \$	Class V Special Trust Units and Exchangeable Units \$	Class T Special Trust Unit \$	Convertible Debenture Conversion Options Not Exercised \$	Total Unitholders' capital \$
Balance, December 31, 2008	59,040,133	1	—	—	59,040,134
Repayment of convertible debentures by issuance of Units	128,184	—	—	—	128,184
Balance, December 31, 2009	59,168,317	1	—	—	59,168,318
Convertible debentures matured [note 9[a]]	—	—	—	11,566	11,566
Balance, December 31, 2010	<u>59,168,317</u>	<u>1</u>	<u>—</u>	<u>11,566</u>	<u>59,179,884</u>

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Units issued during 2009 are summarized as follows:

	Class A Units #	Class V Special Trust Units and Exchangeable Units #	Class T Special Trust Unit #
Balance, December 31, 2008	18,774,756	500,000	1
Repayment of convertible debentures by issuance of Units	283,050	—	—
Balance, December 31, 2009 and 2010	19,057,806	500,000	1

On April 15, 2009, the remaining \$102,000 of the 10% Subordinated Convertible Debentures outstanding at maturity were repaid in full by the issuance of 283,050 Class A Units.

The beneficial interest in Lakeview Hotel REIT is divided into interests of one class and of equal value, referred to as Class A Units, of unlimited number. All Class A Units participate pro rata in any distribution declared on Class A Units and have one vote per Unit.

Exchangeable Units were issued by Lakeview Flag Operating Limited Partnership [note 6]. The Exchangeable Units are exchangeable into 500,000 Class A Units of Lakeview Hotel REIT at the option of the holder. The Exchangeable Units entitle the holders to cash distributions equivalent to the amount of cash distributions that would be allocated to 500,000 Class A Units. In addition, the following were issued in conjunction with the issuance of the Exchangeable Units:

- 500,000 Class V Special Trust Units, one vote per Unit, excluding the right to vote in respect of the election of Trustees, no entitlement to any distribution declared payable on Class A Units, except as declared by the Trustees subject to certain restrictions, cancelled proportionately upon exchange of securities exchangeable into Class A Units.
- One Class T Special Trust Unit, non-transferable, non-voting, right to appoint one-third of the total number of Trustees, no right to any distributions or economic interest in Lakeview Hotel REIT.

Distributions to Unitholders

No distributions were declared during 2010. During 2009, distributions of \$0.01 per Class A Unit and per Exchangeable Unit were declared, totalling \$192,748.

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Distribution policy

The following is a summary of the Lakeview Hotel REIT distribution policy, the full provisions of which are contained in the Declaration of Trust:

Subject to the obligations of the Trustees in respect of the Class V Units, the Trustees may, on or before each Distribution Record Date, and shall on or before the December 31 Distribution Record Date, declare payable, to the Unitholders of record on such Distribution Record Date, all or any part of the Distributable Cash of the Trust for the Distribution Period ending on such Distribution Record Date determined in accordance with the Declaration of Trust, and the proportionate share of each Unit of the amount so payable shall be determined by dividing such amount by the number of Units outstanding on that Distribution Record Date. Each Unitholder's share thereof shall be equal to the proportionate share per Unit multiplied by the number of Units owned of record by the Unitholder on that Distribution Record Date and shall be paid to each such Unitholder on the Distribution Payment Date next following the Distribution Record Date.

"Distributable Cash of the Trust" for the period ending on a Distribution Record Date shall be the amount calculated, for the period commencing immediately following the preceding Distribution Record Date and ending on such Distribution Record Date [each, a "Distribution Period"], as all revenues received or receivable, including net realized capital gains and such other amounts as Lakeview Hotel REIT may receive from time to time in the applicable period, less:

- [a] Administrative and operational expenses and other obligations;
- [b] Amounts which may be used for acquisitions or other business purposes;
- [c] Amounts required for replacement reserves; and
- [d] Such other amounts as the Trustees deem appropriate and necessary.

Items of income or expense not provided for above shall be included in such calculation on such basis as may be considered appropriate by the Trustees.

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12. UNIT PURCHASE PLAN

The Trustees have established a Unit Purchase Plan to provide incentives to Trustees, management and other participants to carry out the business of Lakeview Hotel REIT. The aggregate number of Units reserved for issuance under this plan shall not exceed 1,000,000 Units.

The Unit options outstanding and exercisable under the Unit Purchase Plan are summarized as follows:

	2010		2009	
	Number of options	Weighted average exercise price \$	Number of options	Weighted average exercise price \$
Unit options outstanding, beginning of year	342,000	4.03	342,000	4.03
Unit options granted	775,000	0.28	—	—
Unit options forfeited	(188,250)	3.84	—	—
Unit options outstanding, end of year	928,750	0.94	342,000	4.03

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

2010			2009		
Weighted average exercise price per Unit \$	Number of options	Expiry date	Weighted average exercise price per Unit \$	Number of options	Expiry date
0.28	775,000	2015	—	—	—
4.26	153,750	2011 to 2013	4.03	342,000	2011 to 2013

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The fair values of the options issued in 2010 were estimated using the Black-Scholes option pricing model with the following assumptions and results:

	<u>2010</u>
Distribution yield	0.0%
Expected volatility	64.4%
Risk-free interest rate	2.4%
Estimated compensation costs	\$124,000

The compensation costs were expensed at the date of grant.

13. BASIC AND DILUTED NET LOSS PER UNIT

The basic and diluted net loss per Unit is calculated based on the following:

	<u>2010</u>	<u>2009</u>
Weighted average number of Units	19,557,806	19,477,156

The effect of the options under the Unit Purchase Plan issued to certain Trustees and management [note 12] and the conversion of the convertible debentures [note 9] are not presented as they would have an anti-dilutive effect on the loss per Unit.

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14. RELATED PARTY TRANSACTIONS

In addition to the related party transactions disclosed elsewhere in these consolidated financial statements, during the normal course of business, Lakeview Hotel REIT had the following transactions and balances recorded at their exchange amounts with related parties:

	2010	2009
	\$	\$
Accounts payable and accrued liabilities to		
LMI	1,849,113	614,721
Lakeview Flag Licensing General Partnership <i>[note 6]</i>	475,827	501,629
Lakeview Flag Management General Partnership <i>[note 15]</i>	1,315,283	761,138
Keith Levit Photography	5,179	—
Trustees of Lakeview Hotel REIT	9,000	10,000
Marketing expenses paid to		
Free to Guest Movies Ltd.	185,394	179,925
LMI	204,909	196,253
Keith Levit Photography	1,320	—
Included in general and administration expense		
Accounting fees paid to		
LMI	568,362	564,011
Asset management fees paid to		
LMI	460,544	477,753
Reservation fees paid to		
LMI	307,364	294,380
License fees paid to		
Lakeview Flag Licensing General Partnership <i>[note 6]</i>	821,445	786,499
Management fees paid to		
Lakeview Flag Management General Partnership		
<i>[note 15]</i>	1,246,681	1,211,490
Professional fees paid to		
XYZ Design Inc.	1,160	1,498
Keith Levit Photography	3,704	—
Letter of credit standby fees paid to LMI	—	90,164
Included in salaries and benefits		
Trustees' fees	34,110	39,500
Capitalized to income properties		
Professional fees paid to		
XYZ Design Inc.	—	4,549

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Under the License Agreement [note 6], the following annual fees are paid by Lakeview Hotel REIT to LMI for accounting services, marketing services and access to the on-line reservation system:

Accounting fee	\$30,000 per annum per hotel
Reservation fee	1.5% of gross room revenue
Marketing fee	1% of gross room revenue

[Gross room revenue is defined in note 6.]

The reservation and marketing fees are paid to LMI when properties have been converted to Lakeview Inn & Suites hotels.

The accounting fee shall be increased annually by the year-over-year increase in the Consumer Price Index for the province in which the hotel is located.

Pursuant to a Services Agreement between Lakeview Hotel REIT and LMI, LMI has been engaged as the administrator of Lakeview Hotel REIT, to administer the affairs of Lakeview Hotel REIT on a day-to-day basis and perform the recordkeeping and reporting functions of the Trustees. The initial term of the Services Agreement was for five years expiring on April 14, 2009 and was renewed to April 14, 2014. In consideration, Lakeview Hotel REIT issued to LMI, at the inception of the agreement, options to acquire 50,000 Units, fully vested and exercisable upon issuance at \$1.00 per Unit. LMI exercised its options concurrently with the closing of the Qualifying Transaction.

Effective October 1, 2006, LMI began to charge an asset management fee based on 0.3% of the net book value of income properties. The fee is paid monthly on the last day of every month and is based on the net book value of income properties at the end of the previous month.

Beginning on June 11, 2009, LMI charged a standby fee on the \$2,500,000 of letters of credit it provided in favor of the primary mortgage lender on behalf of Lakeview Hotel REIT [note 10]. The fee was calculated at 2% of the letter of credit amount per annum plus a monthly fee calculated by multiplying the letter of credit amount by the rate that was the difference between the weighted average interest rate on the mortgages held by the mortgage lender [6.31%] and the rate of interest received on funds invested. In November 2009, Lakeview Hotel REIT provided cash collateral to replace the letters of credit provided by LMI and the standby fee was terminated.

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15. INVESTMENT IN LAKEVIEW FLAG MANAGEMENT GENERAL PARTNERSHIP

Lakeview Hotel REIT indirectly acquired a 50% interest in Lakeview Flag Management General Partnership with initial nominal capitalization of \$50, entitling it to 25% of Lakeview Flag Management General Partnership's net income.

Pursuant to a Property Management Agreement, Lakeview Flag Management General Partnership provides hotel management services to each limited service Lakeview Hotel REIT property for a fee equal to 5% of gross revenue and to each full service Lakeview Hotel REIT property for a fee equal to 4% of gross revenue. Gross revenue includes all income derived from the properties and their operations.

Lakeview Hotel REIT's 25% share of the assets, liabilities, revenue, expenses and cash flows are as follows:

	2010 \$	2009 \$
Assets - current	<u>78,894</u>	256,856
Liabilities - current	<u>2,426</u>	1,251
Revenue	415,561	427,233
Expenses	<u>359,698</u>	48
Net income	<u>55,863</u>	427,185
Cash flows		
Cash provided by operating activities	231,965	252,258
Cash used in financing activities	<u>(235,000)</u>	(250,250)
Net increase (decrease) in cash	<u>(3,035)</u>	2,008

Lakeview Hotel Real Estate Investment Trust

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16. FINANCIAL INSTRUMENTS

[a] Fair values

Financial instruments include cash, reserve fund, cash held in trust, accounts receivable, accounts payable and accrued liabilities, loan payable, debentures, convertible debentures and mortgages payable.

The fair values of the \$75,914,044 of mortgages payable to the primary lender approximate the principal balances outstanding of \$76,184,116 as these mortgages are considered short-term liabilities [note 10]. The carrying values of the \$5,064,088 and \$2,000,000 mortgages approximate fair values as they were recently advanced and their interest rates approximate current market rates.

Lakeview Hotel REIT's cash, reserve fund, cash held in trust, accounts receivable and accounts payable and accrued liabilities are carried at amortized cost, which approximates their fair value due to the immediate or short-term nature of these financial instruments.

The carrying value of the loan payable approximates the fair value as it is a demand loan with a floating interest rate based on market interest rates.

Based on trading value and other market factors, the estimated fair value of the debentures approximates their carrying value and the estimated fair values of the 6.5% and 8.5% convertible debentures were \$10,800,000 [2009 - \$12,600,000] and \$6,000,000 [2009 - \$6,500,000] at December 31, 2010, respectively.

Fair value measurements recognized in the consolidated balance sheets are categorized using a fair value hierarchy that reflects the significance of inputs used in determining the fair value.

- Level 1 inputs - unadjusted quoted prices in active markets for identical assets or liabilities;
- Level 2 inputs - inputs other than quoted prices that are observable for the asset or liability, either directly or indirectly; and
- Level 3 inputs - inputs for the asset or liability that are not based on observable market data [unobservable inputs]. These unobservable inputs reflect the entity's own assumptions about the assumptions that the market participants would use in pricing the asset or liability, and are developed based on the best information available in the circumstances.

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Each type of fair value is categorized based on the lowest level that is significant to the fair value measurement in its entirety.

The following table presents the financial instruments recorded at fair value in the consolidated balance sheets, classified using the fair value hierarchy described above:

	2010			2009		
	Level 1 \$	Level 2 \$	Level 3 \$	Level 1 \$	Level 2 \$	Level 3 \$
Financial assets						
Cash	1,436,789	—	—	1,331,392	—	—
Reserve fund	359,868	—	—	651,321	—	—
Cash held in trust	2,510,108	—	—	2,500,000	—	—

[b] Risk management

Management's involvement in operations helps identify risks and variations from expectations. Lakeview Hotel REIT does not manage risk through the use of hedging transactions. As part of the overall operation of Lakeview Hotel REIT, management considers the avoidance of undue concentrations of risk.

It is management's opinion that Lakeview Hotel REIT is not exposed to significant currency risks arising from the financial instruments because it has only minimal foreign currency transactions.

Interest rate risk

Lakeview Hotel REIT is exposed to interest rate risk as it relates to the loan payable with prime-based floating interest rates and the renewal or refinancing of its long-term debts as they become due.

Fluctuations in interest rates create a cash flow risk which is minimized by obtaining long-term mortgages. There is a risk that interest rates will fluctuate subsequent to the date Lakeview Hotel REIT commits to a fixed interest rate with the lender. Obtaining long-term mortgages with fixed interest rates minimizes cash flow risk.

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Credit risk

The amount of accounts receivable disclosed in the consolidated balance sheets of \$1,486,356 as at December 31, 2010 and \$1,075,291 as at December 31, 2009 is net of allowances for bad debts, estimated by management based on prior experience and its assessment of the current economic environment. No customer accounts for more than 10% of the accounts receivable balance as at December 31, 2010 and 2009.

Historically, there have been no collection issues with respect to accounts receivable and Lakeview Hotel REIT does not believe it is subject to any significant concentration of credit risk.

Liquidity risk

Lakeview Hotel REIT is currently subject to substantial liquidity risk. Liquidity risk arises when Lakeview Hotel REIT is unable to meet its financial obligations as they become due. Lakeview Hotel REIT manages liquidity risk through cash flow forecasting and regular monitoring of cash requirements including anticipated investing and financing activities.

As described in note 10, mortgages payable of \$75,914,044 are included in current liabilities as a result of uncertainties associated with Lakeview Hotel REIT's ability to fulfill its commitments under the loan commitment agreement obtained from the primary mortgage lender subsequent to year end and the possibility that it will not be able to comply with the FCCR requirement at December 31, 2011. If the FCCR requirement is not met, these mortgages are considered to be in default and repayment of these mortgages can be demanded at any time. Also included in current liabilities is a \$4,200,000 demand loan from Lakeview Hotel REIT's primary mortgage lender [note 7]. Of this demand loan, \$2,200,000 will be refinanced as part of the mortgages under the loan commitment agreement referred to above. While the remaining loan balance is due on demand, there is currently no indication that repayment will be demanded in 2011.

During 2009, the Trustees announced a suspension of monthly distributions to Unitholders following the February 2009 distribution in order to preserve capital.

Management has considered liquidity risk in using the going concern assumption as described in note 1.

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17. INCOME TAXES

The provision for income taxes varies from the amount that would be expected if computed by applying the Canadian federal and provincial statutory income tax rates to loss before income taxes as shown in the following table:

	2010	2009
	\$	\$
Loss before income taxes	(10,229,404)	(8,068,110)
Temporary differences and non-tax deductible expenses	8,717,746	4,822,147
Loss subject to tax	(1,511,658)	(3,245,963)
Combined federal and provincial income tax at statutory rate of 30% [2009 - 31%]	(453,000)	(1,006,000)
Valuation allowance	453,000	1,006,000
Income tax expense	—	—

Significant components of Lakeview Hotel REIT's future tax assets are shown below:

	2010	2009
	\$	\$
Future tax assets		
Net taxable temporary difference	3,972,000	1,593,000
Taxable portion of non-capital loss carryforward	1,284,000	909,000
Valuation allowance	(5,256,000)	(2,502,000)
	—	—

Based on its assets and liabilities as at December 31, 2010 and 2009, Lakeview Hotel REIT estimated the amount of its temporary differences and the periods in which these differences will reverse. Lakeview Hotel REIT estimates that approximately \$14,710,000 [2009 - \$5,713,000] of net taxable temporary differences and the non-capital loss carryforward of \$4,757,000 [2009 - \$3,246,000] will reverse after January 1, 2011, resulting in \$5,256,000 [2009 - \$2,502,000] of future tax assets. The future tax assets have been reduced by an equivalent valuation allowance as it cannot be determined at this time whether it is more likely than not that Lakeview Hotel REIT will realize the benefits of the future tax assets.

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18. CAPITAL MANAGEMENT

Lakeview Hotel REIT defines capital as the aggregate of unitholders' equity and interest-bearing debt. The objectives of Lakeview Hotel REIT's capital management program are to maintain a level of capital that complies with the debt restrictions according to Lakeview Hotel REIT's Declaration of Trust, complies with existing financial covenants for the mortgages payable [including contributions to the replacement reserve fund], provides a return to Unitholders by delivering monthly cash distributions, optimizes the cost of capital, funds its business strategies and builds long-term Unitholder value.

In managing its capital structure, Lakeview Hotel REIT monitors performance throughout the year to ensure anticipated cash distributions, working capital requirements and capital expenditures are funded from operations, available cash on deposit and available sources of financing. Lakeview Hotel REIT will make adjustments to its capital structure to meet the objectives of the broader corporate strategy or in response to changes in economic conditions and risk. In order to maintain or adjust the capital structure, Lakeview Hotel REIT may issue or redeem units, repay outstanding debt, issue new debt, refinance existing debt under different terms, acquire or dispose of assets or adjust its capital spending to manage its current and projected debt levels.

	2010	2009
	\$	\$
Capital structure		
Loan payable	4,200,000	4,200,000
Debentures	9,907,313	9,703,065
Convertible debentures	25,543,873	24,413,159
Mortgages payable	82,978,132	85,456,608
Total debt	122,629,318	123,772,832
Unitholders' equity	25,408,029	35,513,433
Total capital	148,037,347	159,286,265

In accordance with the Declaration of Trust, Lakeview Hotel REIT ensures the total of all mortgage loans on all income properties is restricted from being greater than 75% of the appraised value of the income properties. As at December 31, 2010 and 2009, the total of mortgage loans payable is 47.4% and 48.4% respectively of the gross book value of income properties.

As disclosed in note 10, as at December 31, 2010, Lakeview Hotel REIT was not in compliance with the FCCR requirement for ten of the hotel properties on which mortgages are held with the primary mortgage lender. However, subsequent to year end, Lakeview Hotel REIT entered into a loan commitment agreement with the mortgage lender to refinance the seven mortgages maturing from February 1, 2011 to July 1, 2011 [with total carrying values of \$27,501,018 as at

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December 31, 2010]. As part of the loan commitment agreement, the lender has agreed to enter into a forbearance agreement regarding its right to demand repayment of the mortgages as a result of the non-compliance of the FCCR requirement at December 31, 2010.

In addition, during 2009, the Trustees announced a suspension of monthly distributions to Unitholders following the February 2009 distribution in order to preserve capital.

19. LEASE COMMITMENT

Lakeview Hotel REIT has entered into an operating lease for land for the Days Inn - Ottawa Airport property. The future minimum annual lease payments under this operating lease for the next five years and thereafter are as follows:

	\$
2011	42,365
2012	42,365
2013	42,365
2014	42,365
2015	42,365
Thereafter	<u>1,292,132</u>
	<u>1,503,957</u>

In addition, Lakeview Hotel REIT is required to pay a percentage rent equal to 1.5% of the annual gross revenue of the Days Inn - Ottawa Airport up to \$2,000,000 and 1% of the annual gross revenue in excess of \$2,000,000.