

Consolidated Financial Statements

**Lakeview Hotel Real Estate Investment Trust**

December 31, 2008 and 2007

## AUDITORS' REPORT

To the Unitholders of  
**Lakeview Hotel Real Estate Investment Trust**

We have audited the consolidated balance sheets of **Lakeview Hotel Real Estate Investment Trust** as at December 31, 2008 and 2007 and the consolidated statements of income (loss) and comprehensive income (loss), unitholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Trust's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an 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 **Lakeview Hotel Real Estate Investment Trust** 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.

Winnipeg, Canada,  
April 28, 2009.

*Ernst & Young LLP*

Chartered Accountants

## Lakeview Hotel Real Estate Investment Trust

### CONSOLIDATED BALANCE SHEETS

As at December 31

	2008	2007
	\$	\$
<b>ASSETS</b>		
<b>Current</b>		
Cash and cash equivalents	1,751,665	3,883,533
Reserve fund <i>[note 3]</i>	545,824	1,237,214
Deposits held in trust	300,000	—
Accounts receivable	1,479,824	2,030,665
Inventory	119,775	142,103
Prepaid expenses	187,549	301,449
Current portion of mortgages receivable <i>[note 4]</i>	150,000	—
<b>Total current assets</b>	<b>4,534,637</b>	<b>7,594,964</b>
Mortgages receivable <i>[note 4]</i>	4,902,767	—
Franchise fees, licenses and pre-opening costs <i>[note 5]</i>	166,188	156,432
Income properties <i>[notes 2, 6, 8, 9, 11 and 15]</i>	161,853,740	144,810,596
Investment in Lakeview Flag Licensing General Partnership <i>[note 7]</i>	120,171	40,367
	<b>171,577,503</b>	<b>152,602,359</b>
<b>LIABILITIES AND UNITHOLDERS' EQUITY</b>		
<b>Current</b>		
Accounts payable and accrued liabilities <i>[note 15]</i>	3,154,468	2,772,776
Distributions payable	192,748	707,188
Loan payable <i>[note 8]</i>	4,200,000	—
Current portion of convertible debentures <i>[note 10]</i>	98,799	—
Current portion of mortgages payable <i>[note 11]</i>	9,362,752	2,211,080
<b>Total current liabilities</b>	<b>17,008,767</b>	<b>5,691,044</b>
Debentures <i>[note 9]</i>	9,519,251	—
Convertible debentures <i>[note 10]</i>	23,377,662	14,318,230
Mortgages payable <i>[note 11]</i>	77,999,532	80,158,092
Future income tax liability <i>[note 18]</i>	—	734,000
<b>Total liabilities</b>	<b>127,905,212</b>	<b>100,901,366</b>
<b>Unitholders' equity</b>	<b>43,672,291</b>	<b>51,700,993</b>
	<b>171,577,503</b>	<b>152,602,359</b>

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 INCOME (LOSS) AND  
COMPREHENSIVE INCOME (LOSS)**

Years ended December 31

	2008	2007
	\$	\$
<b>REVENUE</b>		
Rooms	35,134,621	26,571,849
Food, beverage and gift shop	3,732,213	4,134,751
Income from Lakeview Flag Licensing General Partnership <i>[note 7]</i>	617,334	547,807
Interest and miscellaneous	1,264,173	762,295
	<u>40,748,341</u>	<u>32,016,702</u>
<b>EXPENSES</b>		
Amortization		
Franchise fees, licenses and pre-opening costs	48,534	34,969
Income properties	6,212,645	4,592,915
Food, beverage and gift shop	1,502,303	1,665,270
General and administration <i>[note 15]</i>	7,964,682	6,146,914
Insurance	319,743	265,584
Interest		
Loan and other	140,720	125,353
Mortgages and debentures	8,852,819	4,818,627
Maintenance	907,621	632,254
Marketing <i>[note 15]</i>	2,618,499	1,805,117
Property taxes	1,795,088	1,280,478
Rent <i>[note 20]</i>	38,161	—
Salaries and benefits	10,081,393	7,691,449
Supplies	936,754	818,425
Utilities	1,584,807	1,148,936
	<u>43,003,769</u>	<u>31,026,291</u>
Income (loss) before income taxes	(2,255,428)	990,411
Provision for (recovery of) income taxes - future	(734,000)	734,000
<b>Net income (loss) and comprehensive income (loss) for the year</b>	<u>(1,521,428)</u>	<u>256,411</u>
Basic and diluted net income (loss) and comprehensive income (loss) per Unit <i>[note 14]</i>	<u>(0.079)</u>	<u>0.014</u>

*See accompanying notes*

Lakeview Hotel Real Estate Investment Trust

**CONSOLIDATED STATEMENTS OF  
UNITHOLDERS' EQUITY**

Years ended December 31

	2008	2007
	\$	\$
<b>Unitholders' capital</b> <i>[note 12]</i>		
Balance, beginning of year	59,021,720	55,901,339
Issuance of Units on exercise of Unit options	—	19,850
Conversion of debentures	18,414	3,100,531
Balance, end of year	<u>59,040,134</u>	<u>59,021,720</u>
<b>Equity portion of convertible debentures</b>		
Balance, beginning of year	2,883,536	823,836
Issuance of convertible debentures <i>[note 10]</i>	954,268	3,062,813
Conversion of debentures	(1,757)	(786,086)
Issuance costs	(75,692)	(217,027)
Balance, end of year	<u>3,760,355</u>	<u>2,883,536</u>
<b>Contributed capital</b>		
Balance, beginning of year	345,900	45,000
Issuance of Unit options <i>[note 13]</i>	55,845	304,500
Issuance of Units on exercise of Unit options	—	(3,600)
Balance, end of year	<u>401,745</u>	<u>345,900</u>
<b>Accumulated earnings</b>		
Balance, beginning of year	2,813,017	2,556,606
Net income (loss) and comprehensive income (loss) for the year	(1,521,428)	256,411
Balance, end of year	<u>1,291,589</u>	<u>2,813,017</u>
<b>Accumulated distributions</b>		
Balance, beginning of year	(13,363,180)	(5,011,551)
Distributions declared <i>[note 12]</i>	(7,458,352)	(8,351,629)
Balance, end of year	<u>(20,821,532)</u>	<u>(13,363,180)</u>
<b>Unitholders' equity, end of year</b>	<u>43,672,291</u>	<u>51,700,993</u>

See accompanying notes

## Lakeview Hotel Real Estate Investment Trust

### CONSOLIDATED STATEMENTS OF CASH FLOWS

Years ended December 31

	2008	2007
	\$	\$
<b>OPERATING ACTIVITIES</b>		
Net income (loss) for the year	(1,521,428)	256,411
Add (deduct) items not involving cash		
Amortization of income properties	6,212,645	4,592,915
Amortization of franchise fees, licenses and pre-opening costs	48,534	34,969
Compensation costs of Unit options <i>[note 13]</i>	55,845	304,500
Income from Lakeview Flag Licensing General Partnership <i>[note 7]</i>	(617,334)	(547,807)
Accretion on debt component of convertible debentures <i>[note 10]</i>	846,657	382,613
Accretion of debentures <i>[note 9]</i>	124,372	—
Accretion of mortgages payable	204,192	137,188
Decretion of mortgages receivable <i>[note 4]</i>	6,879	—
Future income tax expense (recovery)	(734,000)	734,000
	<u>4,626,362</u>	<u>5,894,789</u>
Net change in non-cash working capital balances related to operations	1,000,865	530,864
<b>Cash provided by operating activities</b>	<u>5,627,227</u>	<u>6,425,653</u>
<b>INVESTING ACTIVITIES</b>		
Acquisition of income properties, cash consideration <i>[note 2]</i>	(13,841,391)	(66,050,907)
Additions to income properties	(2,469,551)	(2,233,008)
Increase in franchise fees, licenses and pre-opening costs	(58,290)	(44,408)
Advance of mortgages receivable <i>[note 4]</i>	(5,000,000)	—
Transaction costs on advance of mortgages receivable <i>[note 4]</i>	(59,646)	—
Distributions from Lakeview Flag Licensing General Partnership <i>[note 7]</i>	537,530	537,530
<b>Cash used in investing activities</b>	<u>(20,891,348)</u>	<u>(67,790,793)</u>
<b>FINANCING ACTIVITIES</b>		
Unitholders' distributions		
Class A	(7,264,852)	(8,131,462)
Exchangeable Units	(193,500)	(220,167)
Proceeds from loan	7,000,000	8,280,000
Repayment of loan	(2,800,000)	(8,530,000)
Proceeds from mortgages	—	47,820,000
Repayment of mortgages	(2,211,080)	(1,378,454)
Proceeds of debentures <i>[note 9]</i>	10,250,000	—
Proceeds of convertible debentures <i>[notes 10[c] and [d]]</i>	10,000,000	18,000,000
Financing costs on mortgages, debentures and convertible debentures	(1,648,315)	(1,839,095)
Issuance of Units on exercise of Unit options	—	16,250
<b>Cash provided by financing activities</b>	<u>13,132,253</u>	<u>54,017,072</u>
<b>Net decrease in cash and cash equivalents during the year</b>	<u>(2,131,868)</u>	<u>(7,348,068)</u>
Cash and cash equivalents, beginning of year	3,883,533	11,231,601
<b>Cash and cash equivalents, end of year</b>	<u>1,751,665</u>	<u>3,883,533</u>
<b>Supplemental cash flow information</b>		
Cash paid for interest	7,736,253	4,221,940

See accompanying notes

## Lakeview Hotel Real Estate Investment Trust

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2008 and 2007

## 1. ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

### Organization and basis of presentation

Lakeview Hotel Real Estate Investment Trust ["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 [the "Initial Property"] 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 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.

## Lakeview Hotel Real Estate Investment Trust

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#### Significant accounting policies

##### [a] Cash and cash equivalents

Cash and cash equivalents consist of cash and guaranteed investment certificates with maturities of less than 90 days from the date of issuance and are readily convertible to cash.

##### [b] Inventory

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

##### [c] Franchise fees, licenses and pre-opening costs

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 or 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.

Pre-opening costs were incurred with respect to the opening of the Local Heroes restaurant at the Lakeview Inn & Suites - Fort Saskatchewan on June 15, 2007 and include training, travel and salaries. Pre-opening costs are stated at cost less accumulated amortization. Amortization is recorded using the straight-line method over three years.

##### [d] Income properties

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

Income properties are stated at the lower of cost less accumulated amortization or estimated net recoverable amount. Impairment of income properties is recognized when an event or change in circumstances causes the asset's carrying value to exceed the total undiscounted cash flows expected from its use and eventual disposition. The impairment loss is calculated by deducting the fair value of the asset from its carrying value.

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

## Lakeview Hotel Real Estate Investment Trust

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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Amortization is recorded as follows:

Buildings	Straight-line over 40 years
Parking lots	Straight-line over 10 years
Signs	Straight-line over 10 years
Furniture, fixtures and equipment	Straight-line over 3 - 10 years

#### [e] 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.

#### [f] Related parties

During 2008 and 2007, 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

#### [g] 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 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.

## Lakeview Hotel Real Estate Investment Trust

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

#### **[h] 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 28%. Temporary differences reversing before 2011 will still give rise to nil future income taxes.

While Lakeview Hotel REIT believes it will be subject to additional tax under the new legislation, the estimated effective tax rate on temporary difference reversals after 2011 may change in future periods. As the legislation is new, future technical interpretations of the legislation could occur and could materially affect management's estimate of the future income tax liability.

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 tax liability.

#### **[i] Net income (loss) and comprehensive income (loss) per unit**

Net income (loss) and comprehensive income (loss) per unit is based on the consolidated net income (loss) for the year divided by the weighted average number of units outstanding during the year. Diluted income (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.

#### **[j] Stock-based compensation plan**

Lakeview Hotel REIT has a Unit Purchase Plan as described in note 13. 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.

## Lakeview Hotel Real Estate Investment Trust

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2008 and 2007

#### [k] Use of estimates

The preparation of financial statements in accordance 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 contingencies at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates.

#### [l] Financial instruments

Lakeview Hotel REIT has the following financial assets and liabilities:

- Cash and cash equivalents, reserve fund and deposits 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 income (loss).
- Accounts receivable and mortgages 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. Under the effective interest method, transaction costs are added to the receivable to which they relate. Over its term, the long-term receivable will decrease to its face value with the decrease being applied against interest income earned on the mortgages receivable. The reduced interest income is reflected on the consolidated statements of income (loss) and comprehensive income (loss).
- Accounts payable and accrued liabilities, distributions payable, 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 or interest on debentures and convertible debentures on the consolidated statements of income (loss) and comprehensive income (loss).

Fair value is based on quoted market prices when available. However, when financial instruments lack an available trading market, fair value is determined using management's estimates and is calculated using market factors with similar characteristics and risk profiles.

## Lakeview Hotel Real Estate Investment Trust

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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#### **[m] New accounting standards adopted in 2008**

##### Capital Disclosures and Financial Instruments – Presentation and Disclosure

The Canadian Institute of Chartered Accountants ["CICA"] issued three new accounting standards: Section 1535, "Capital Disclosures"; Section 3862, "Financial Instruments – Disclosures"; and Section 3863, "Financial Instruments – Presentation". These new standards are effective for fiscal years beginning on or after October 1, 2007 and Lakeview Hotel REIT has adopted them on January 1, 2008.

Section 1535 establishes disclosure requirements about an entity's capital and how it is managed. The additional disclosures include quantitative and qualitative information about the entity's objectives, policies and processes for managing capital. This information is disclosed in note 19.

Sections 3862 and 3863 replaced Section 3861, "Financial Instruments – Disclosure and Presentation", revising and enhancing its disclosure requirements and carrying forward the presentation requirements. These new sections place increased emphasis on disclosures about the nature and extent of risk arising from financial instruments and how the entity manages those risks. This information is disclosed in note 17.

#### **[n] Future accounting changes**

##### Goodwill and intangible assets

The CICA has issued a new accounting standard, Section 3064, "Goodwill and Intangible Assets", which establishes new standards for the recognition, measurement, presentation and disclosure of goodwill and intangible assets. Section 1000, "Financial Statement Concepts", was also amended to provide consistency with Section 3064. The new and amended standards will be effective for the Lakeview Hotel REIT's 2009 fiscal year. These new standards are not expected to have a material impact on Lakeview Hotel REIT's 2009 consolidated financial statements.

##### Business combinations, consolidated financial statements and non-controlling interests

The CICA has issued new accounting standards, Section 1582, "Business Combinations", Section 1601, "Consolidated Financial Statements", and Section 1602, "Non-controlling Interests", which establish new standards for consolidated financial statements and business combinations. The definition of a business is expanded and described as an integrated set of activities and assets that are capable of being managed to provide a return to investors or economic benefits to owners, members or participants. Net assets, non-controlling interests and goodwill acquired in a business combination will be recorded at fair value. Non-controlling interests will be reported as a component of equity. In addition, acquisition costs will be expensed when incurred. The new and

## Lakeview Hotel Real Estate Investment Trust

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amended standards will be effective for the Lakeview Hotel REIT's 2011 fiscal year. The objective of these new sections is to harmonize Canadian generally accepted accounting principles with International Financial Reporting Standards ["IFRS"]. When these standards are adopted by Lakeview Hotel REIT, acquisition costs will be expensed through the income statement. Other impacts of these standards are still being assessed.

#### International Financial Reporting Standards ["IFRS"]

In 2005, the Accounting Standards Board [AcSB] announced that the accounting standards in Canada are to converge with IFRS. On February 13, 2008, the CICA had confirmed that the use of IFRS will be required by January 1, 2011, with appropriate comparative data from the prior year. Under IFRS, the primary audience is capital markets and, as a result, there is significantly more disclosure required, specifically for quarterly reporting. Further, while IFRS uses a conceptual framework similar to Canadian generally accepted accounting principles, there are significant differences in accounting policy that must be addressed. Lakeview Hotel REIT has begun assessing the adoption of IFRS for 2011, by beginning its assessment of the key accounting differences between Canadian generally accepted accounting principles and IFRS as it relates to the accounting policies of Lakeview Hotel REIT.

## 2. ACQUISITION OF HOTELS

In 2008 and 2007, Lakeview Hotel REIT acquired certain hotels. The acquisitions have been accounted for by the purchase method with the results of operations from the acquired hotels included in Lakeview Hotel REIT's earnings from the date of their respective acquisitions. The assets and liabilities acquired at fair value were as follows:

### 2008

	Acquisition date	Land \$	Buildings \$	Signs \$	Furniture, fixtures and equipment \$	Working capital \$	Mortgage payable - first \$	Cash consider- ation \$
<b>British Columbia</b>								
Four Points by Sheraton - Prince George	2008-04-03	1,032,184	8,231,667	65,869	775,000	4,675	—	10,109,395
<b>Ontario</b>								
Days Inn - Ottawa Airport	2008-08-01	—	9,958,538	50,000	672,979	50,479	(7,000,000)	3,731,996
		<u>1,032,184</u>	<u>18,190,205</u>	<u>115,869</u>	<u>1,447,979</u>	<u>55,154</u>	<u>(7,000,000)</u>	<u>13,841,391</u>

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Cash consideration for the purchase of the hotels in 2008 was financed from proceeds from the public offering of debentures on March 28, 2008 [note 9], the loan payable [note 8] and working capital.

#### 2007

	Acquisition date	Land \$	Building \$	Parking lot \$	Furniture, fixtures and equipment \$	Working capital \$	Cash consideration \$
<b>Alberta</b>							
Lakeview Inn & Suites - Edson Airport West	2007-04-16	604,909	6,633,839	—	600,000	(2,042)	7,836,706
Lakeview Inn & Suites - Brooks	2007-05-15	796,065	9,446,644	—	600,000	(14,414)	10,828,295
Lakeview Signature Inn - Calgary	2007-06-22	2,690,246	22,098,577	181,074	1,850,338	(6,941)	26,813,294
Lakeview Inn & Suites - Slave Lake*	2007-11-15	523,380	9,390,654	—	450,000	7,421	10,371,455
<b>British Columbia</b>							
Lakeview Inn & Suites - Fort Nelson	2007-01-08	763,082	8,795,788	—	647,235	(4,948)	10,201,157
		<u>5,377,682</u>	<u>56,365,502</u>	<u>181,074</u>	<u>4,147,573</u>	<u>(20,924)</u>	<u>66,050,907</u>

\* Converted to a Lakeview Inn & Suites hotel on January 1, 2008.

Cash consideration for the purchase of the hotels in 2007 was financed by a combination of proceeds from the private placement of Class A Units, first mortgages [note 11], the loan payable [note 8], proceeds from a public offering of convertible debentures on June 20, 2007 [note 10] and working capital.

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#### 3. RESERVE FUND

Pursuant to the Hotel Management Agreements with Lakeview Flag Management General Partnership, the Lakeview Hotel REIT properties are required to reserve funds in a separate account for on-going 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 account equal to not less than 2% of monthly gross revenue.

	2008	2007
	\$	\$
<b>Reserve fund, beginning of year</b>	<b>1,237,214</b>	622,779
Allocations to reserve fund	<b>1,160,788</b>	951,428
Use of reserve fund	<b>(1,852,178)</b>	(336,993)
<b>Reserve fund, end of year</b>	<b>545,824</b>	1,237,214

During 2008, included in the use of reserve fund was an amount of \$720,000 withdrawn to fund operations. This amount was the allocations to reserve fund in the current year and prior years that was in excess of the 2% of monthly gross revenue requirement.

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#### 4. MORTGAGES RECEIVABLE

The mortgages receivable represent amounts advanced under a mezzanine loan arrangement with an independent hotel developer and its related parties for three hotels in British Columbia and Alberta. The mortgages receivable earn interest at 12% per annum compounded and payable monthly. Payments of interest only are received on the mortgages. The principal is due no later than the maturity of the mortgages, which is 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 on August 1, 2008. Lakeview Hotel REIT has the right to demand repayment of \$1,000,000 of the principal after January 14, 2009. Subsequent to year end, \$150,000 was collected on the mortgages receivable. Details of the mortgages are as follows:

	2008 \$	2007 \$
Principal	5,000,000	—
Transaction costs	59,646	—
Decretion of mortgages receivable	(6,879)	—
	<u>5,052,767</u>	—
Less current portion	(150,000)	—
	<u>4,902,767</u>	—

As Lakeview Hotel REIT invests in mortgages to facilitate acquisitions, credit risks arise in the event that the borrowers default on the repayment of their mortgages to Lakeview Hotel REIT. The maximum exposure to credit risk associated with mortgages receivable occurs if all borrowers default on repayment of their mortgages to Lakeview Hotel REIT. Therefore, the carrying value of the mortgages receivable balance represents Lakeview Hotel REIT's maximum exposure to related credit risk without taking into account any collateral held or any other credit enhancements. Lakeview Hotel REIT has mitigated this risk by registering first and/or second mortgage charges against two different hotel properties owned by the borrower as well as against other collateral security. The mortgages receivable are also secured by an assignment of leases and material contracts on three properties and corporate and personal guarantees from the borrowers. As a result of the above, Lakeview Hotel REIT considers the credit quality of these financial assets to be adequate. Accordingly, there were no impairments or impairment provisions recorded for mortgages receivable as at December 31, 2008.

Lakeview Hotel REIT has been granted the option to purchase three hotel properties from the borrowers at any time prior to the later of [a] the second anniversary of the date on which the last advance of mortgage funds under the loan was made to the owners or [b] the date the mortgages are repaid in full by the owners. The purchase price for the lands and hotel businesses upon exercise of the option will range from \$115,000 to \$130,000 per room/suite in the hotels. The

## Lakeview Hotel Real Estate Investment Trust

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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purchase price will be reduced by any amounts owing to Lakeview Hotel REIT by the owners under the mortgages for each hotel purchased pursuant to the options. Prior to purchase, all three hotels have been licensed and are operating as Lakeview Inn & Suites and are paying license fees to Lakeview Flag Licensing General Partnership [note 7].

#### 5. FRANCHISE FEES, LICENSES AND PRE-OPENING COSTS

	2008 \$	2007 \$
Cost	261,379	203,089
Less accumulated amortization	(95,191)	(46,657)
	<b>166,188</b>	<b>156,432</b>

#### 6. INCOME PROPERTIES

	2008			2007		
	Cost \$	Accumulated amortization \$	Net book value \$	Cost \$	Accumulated amortization \$	Net book value \$
Land	15,493,719	—	15,493,719	14,388,297	—	14,388,297
Buildings	144,204,778	7,455,700	136,749,078	124,902,646	4,064,291	120,838,355
Parking lots	492,373	88,204	404,169	389,197	46,130	343,067
Signs	534,138	80,642	453,496	406,865	39,481	367,384
Furniture, fixtures and equipment	14,789,121	6,035,843	8,753,278	12,181,200	3,307,707	8,873,493
	<b>175,514,129</b>	<b>13,660,389</b>	<b>161,853,740</b>	<b>152,268,205</b>	<b>7,457,609</b>	<b>144,810,596</b>

Effective March 1, 2007, Lakeview Hotel REIT acquired approximately 2/3 of an acre of land adjacent to the Lakeview Inn & Suites in Edson, Alberta for total consideration including closing adjustments of \$365,753. The cash consideration for the purchase was financed out of working capital.

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#### 7. 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"] and 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 generally accepted accounting principles 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 License Agreement, 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 earns a license fee of 4% of gross room revenue from the Lakeview Inn & Suites – Tumbler Ridge [located in British Columbia] effective September 1, 2008, the Lakeview Inn & Suites – Hudson's Hope [also located in British Columbia] effective September 17, 2008 and the Lakeview Inn & Suites – Fox Creek [located in Alberta] effective November 4, 2008 [note 4].

## Lakeview Hotel Real Estate Investment Trust

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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:

	2008	2007
	\$	\$
<b>Investment, beginning of year</b>	40,367	30,090
Equity income	617,334	547,807
Distribution received	(537,530)	(537,530)
<b>Investment, end of year</b>	<b>120,171</b>	40,367

#### 8. LOAN PAYABLE

	2008	2007
	\$	\$
Loan payable	<b>4,200,000</b>	—

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 dollar bankers' acceptance rate plus 4.25% to 5% floating per annum, due on demand, collateralized by first mortgages on certain income properties. The effective interest rate was 7.42% in 2008.

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#### 9. 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 with the first payment occurring on April 30, 2008. 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 a price equal to 110% of the principal amount plus accrued and unpaid interest up to, but excluding the date of redemption.

	2008	2007
	\$	\$
Principal	10,250,000	—
Financing costs	(855,121)	—
Accretion of debentures	124,372	—
	<u>9,519,251</u>	<u>—</u>

## Lakeview Hotel Real Estate Investment Trust

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#### 10. 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 \$
10% Subordinated Convertible Debentures	3,344,822	1,155,178	4,500,000
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
	<b>28,394,023</b>	<b>5,605,977</b>	<b>34,000,000</b>

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

Debenture	2008			
	Effective interest rate %	Original face amount \$	Converted to trust units \$	Face amount outstanding \$
10% Subordinated Convertible Debentures	18%	4,500,000	4,398,000	102,000
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
		<b>34,000,000</b>	<b>5,878,000</b>	<b>28,122,000</b>

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Debenture	2008				
	Face amount outstanding \$	Holders' conversion option \$	Accretion \$	Financing costs \$	December 31, 2008 \$
<b>Current</b>					
10% Subordinated Convertible Debentures	102,000	(26,184)	32,707	(9,724)	98,799
<b>Long-term</b>					
9% Subordinated Convertible Debentures	40,000	(11,566)	9,212	(3,610)	34,036
6.5% Series C Convertible Redeemable Subordinated Debentures	18,000,000	(3,062,813)	991,065	(1,058,428)	14,869,824
8.5% Series D Convertible Redeemable Subordinated Debentures	9,980,000	(952,360)	162,229	(716,067)	8,473,802
	<b>28,020,000</b>	<b>(4,026,739)</b>	<b>1,162,506</b>	<b>(1,778,105)</b>	<b>23,377,662</b>
	<b>28,122,000</b>	<b>(4,052,923)</b>	<b>1,195,213</b>	<b>(1,787,829)</b>	<b>23,476,461</b>
Debenture	2007				
	Effective interest rate %	Original face amount \$	Converted to trust units \$	Face amount outstanding \$	
10% Subordinated Convertible Debentures	18%	4,500,000	4,398,000	102,000	
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	
		<b>24,000,000</b>	<b>5,858,000</b>	<b>18,142,000</b>	

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Debtenture	2007				December 31, 2007 \$
	Face amount outstanding \$	Holders' conversion option \$	Accretion \$	Financing costs \$	
10% Subordinated Convertible Debentures	102,000	(26,184)	22,876	(9,724)	88,968
9% Subordinated Convertible Debentures	40,000	(11,566)	5,930	(3,610)	30,754
6.5% Series C Convertible Redeemable Subordinated Debentures	18,000,000	(3,062,813)	319,749	(1,058,428)	14,198,508
	<u>18,142,000</u>	<u>(3,100,563)</u>	<u>348,555</u>	<u>(1,071,762)</u>	<u>14,318,230</u>

The accretion of the debt component, which increases the debt component from the initial carrying amount, is included in interest expense and totalled \$846,657 [2007 - \$382,613].

#### [a] 10% Subordinated Convertible Debentures

On April 15, 2004, under a public offering, Lakeview Hotel REIT issued \$4,500,000 of 10% Subordinated Convertible Debentures.

The debentures bear interest at 10%, mature in five years from date of issue 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 during the third year after the date of issue at the following conversion price per Unit: \$2.50 in year three; \$3.00 in year four; and \$3.50 in year five. At any time after three 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. 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 trading day period], or in any other combination thereof.

During 2007, \$1,896,000 of the debentures were converted at a price of \$2.50 into 758,400 Class A Units and \$175,000 of the debentures were converted at a price of \$3.00 into 58,331 Class A Units.

Subsequent to year end, the remaining outstanding 10% Subordinated Convertible Debentures were repaid in full by issuance of 283,050 units.

## Lakeview Hotel Real Estate Investment Trust

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#### **[b] 9% Subordinated Convertible Debentures**

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

The debentures bear interest at 9%, mature in five years from date of issue 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 \$2.90 per Unit.

During 2007, \$880,000 of the debentures were converted at a price of \$2.90 into 303,440 Class A Units.

#### **[c] 6.5% Series C Convertible Redeemable Subordinated Debentures**

On June 20, 2007, under a public offering, Lakeview Hotel REIT issued \$18,000,000 of 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.

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 trading day period], or in any other combination thereof.

#### **[d] 8.5% Series D Convertible Redeemable Subordinated Debentures**

On May 8, 2008, under a public offering, Lakeview Hotel REIT issued \$10,000,000 of 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 9]. The debentures are convertible by the holder at any time prior to maturity at \$3.75 per Unit.

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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 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.

During 2008, \$20,000 of the debentures were converted at a price of \$3.75 into 5,333 Class A Units.

#### 11. MORTGAGES PAYABLE

	2008 \$	2007 \$
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 <i>[note 9]</i> and Days Inn – Ottawa Airport	80,362,284	82,369,172
Mortgage payable, bearing interest at 7% per annum, due August 1, 2009, 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 by both Lakeview Hotel REIT and Lakeview Flag Operating Limited Partnership. Payments of interest only are due on the mortgage	7,000,000	—
	<u>87,362,284</u>	<u>82,369,172</u>
Less current portion	9,362,752	2,211,080
	<u>77,999,532</u>	<u>80,158,092</u>

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The long-term mortgage agreements 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 addition, based on management's forecast, Lakeview Hotel REIT is not expected to meet the FCCR requirement for these six hotel properties at December 31, 2009. Subsequent to year end, 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 and the expected FCCR covenant breach at December 31, 2009. Accordingly, the mortgages payable are classified as long-term liabilities in these financial statements. As conditions for the lender's agreement, two letters of credit of \$1,250,000 each are to be provided in favor of the mortgage lender that it can draw upon in the event of default. In addition, a forbearance fee of \$350,000 is to be paid by Lakeview Hotel REIT.

Management is in the final stages of completing the refinancing of the \$7,000,000 mortgage on the Days Inn - Ottawa Airport with long-term mortgages. Should Lakeview Hotel REIT be unable to complete the refinancing or renew the mortgage with the current lender, the current lender has the right to take ownership of the hotel property of Days Inn - Ottawa Airport.

Estimated future principal repayments over the next five years and thereafter, based on the repayment schedules of the mortgages, are as follows:

	\$
2009	9,362,752
2010	2,513,112
2011	29,087,884
2012	30,460,243
2013	4,743,265
Thereafter	<u>11,892,725</u>
Total principal outstanding	88,059,981
Financing costs	(1,097,242)
Accretion of mortgages	399,545
	<u>87,362,284</u>

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#### 12. UNITHOLDERS' CAPITAL

	Class A Units \$	Class V Special Trust Units and Exchangeable Units \$	Class T Special Trust Unit \$	Total Unitholders' capital \$
<b>Balance, December 31, 2006</b>	55,901,338	1	—	55,901,339
Conversion of debentures <i>[note 10]</i>	3,100,531	—	—	3,100,531
Issuance of Units on exercise of Unit options <i>[note 13]</i>	19,850	—	—	19,850
<b>Balance, December 31, 2007</b>	59,021,719	1	—	59,021,720
Conversion of debentures <i>[note 10]</i>	18,414	—	—	18,414
<b>Balance, December 31, 2008</b>	<b>59,040,133</b>	<b>1</b>	<b>—</b>	<b>59,040,134</b>

Units issued during 2008 and 2007 are summarized as follows:

	Class A Units #	Class V Special Trust Units and Exchangeable Units #	Class T Special Trust Unit #
<b>Balance, December 31, 2006</b>	17,644,252	500,000	1
Conversion of debentures <i>[note 10]</i>	1,120,171	—	—
Issuance of Units on exercise of Unit options <i>[note 13]</i>	5,000	—	—
<b>Balance, December 31, 2007</b>	18,769,423	500,000	1
Conversion of debentures <i>[note 10]</i>	5,333	—	—
<b>Balance, December 31, 2008</b>	<b>18,774,756</b>	<b>500,000</b>	<b>1</b>

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.

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Exchangeable Units were issued by Lakeview Flag Operating Limited Partnership [note 7]. 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 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

For the year ended December 31, 2008, distributions of \$0.39 [2007 - \$0.44] per Class A Unit and per Exchangeable Unit were declared, totalling \$7,458,352 [2007 - \$8,351,629].

#### 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

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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.

#### 13. 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 five percent [5%] of the total number of issued and outstanding units.

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

	2008		2007	
	Number of options	Weighted average exercise price \$	Number of options	Weighted average exercise price \$
<b>Unit options outstanding, beginning of year</b>	<b>232,500</b>	<b>4.28</b>	62,500	3.25
Unit options granted	<b>109,500</b>	<b>3.50</b>	175,000	4.62
Unit options exercised	—	—	(5,000)	3.25
<b>Unit options outstanding, end of year</b>	<b>342,000</b>	<b>4.03</b>	232,500	4.28
Range of exercise price of Unit options outstanding, end of year	—	<b>3.25 to 4.62</b>	—	3.25 to 4.62
Unit options vested, end of year	<b>342,000</b>	<b>4.03</b>	232,500	4.28
Expiry date	<b>2011 to 2013</b>		2011 to 2012	

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

	<u>2008</u> <u>Options</u>	<u>2007</u> <u>Options</u>
Distribution yield	12.6%	8.8%
Expected volatility	49.2%	52.7%
Risk-free interest rate	3.0%	4.8%
Estimated compensation costs	<u>\$55,845</u>	<u>\$304,500</u>

The compensation costs were expensed at the date of grant.

#### 14. BASIC AND DILUTED INCOME (LOSS) PER UNIT

The basic and diluted income (loss) per Unit is calculated based on the following:

	<u>2008</u>	<u>2007</u>
Weighted average Units	<u>19,272,512</u>	<u>18,932,335</u>

The effect of the options under the Unit Purchase Plan issued to certain Trustees and management [note 13] and the conversion of the convertible debentures [note 10] are not presented as they would have an anti-dilutive effect on the income (loss) per Unit.

## Lakeview Hotel Real Estate Investment Trust

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#### 15. 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 value with related parties:

	2008	2007
	\$	\$
Accounts payable and accrued liabilities to		
LMI	136,923	83,277
Lakeview Flag Licensing General Partnership <i>[note 7]</i>	156,226	61,503
Lakeview Flag Management General Partnership <i>[note 16]</i>	237,068	83,686
XYZ Design Inc.	—	6,906
Trustees of Lakeview Hotel REIT	9,920	—
Marketing expenses paid to		
Free to Guest Movies Ltd.	160,704	175,079
LMI	394,930	213,438
Included in general and administration expense		
Accounting fees paid to		
LMI	530,879	426,327
Asset management fees paid to		
LMI	459,897	346,631
Reservation fees paid to		
LMI	394,930	320,117
License fees paid to		
Lakeview Flag Licensing General Partnership <i>[note 7]</i>	1,053,858	853,741
Management fees paid to		
Lakeview Flag Management General Partnership <i>[note 16]</i>	1,421,802	1,132,348
Professional fees paid to		
XYZ Design Inc.	5,637	14,972
Capitalized to income properties		
Professional fees paid to		
XYZ Design Inc.	50,201	21,236
Keith Levit Photography	22,695	8,825
Development fees paid to LMI	35,549	44,181

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Under the License Agreement [note 7], 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	1.5% [2007 - 1%] of gross room revenue

[Gross room revenue is defined in note 7.]

The reservation and marketing fees are paid to LMI when properties have been converted to Lakeview Inn & Suites hotels. As of January 1, 2009, the marketing fee was decreased to 1% of gross room revenue.

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 record keeping and reporting functions of the Trustees. The initial term of the Services Agreement is 5 years expiring on April 14, 2009 and has been renewed until 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.

#### 16. INVESTMENT IN LAKEVIEW FLAG MANAGEMENT GENERAL PARTNERSHIP

Lakeview Hotel REIT indirectly acquired a 50% interest in the 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

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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, revenues, expenses and cash flows are as follows:

	2008	2007
	\$	\$
Assets - current	<u>80,157</u>	28,890
Liabilities - current	<u>1,487</u>	1,577
Revenue	474,143	377,735
Expenses	36	75
Net income	<u>474,107</u>	<u>377,660</u>
Cash flows		
Cash provided by operating activities	422,863	373,352
Cash used in financing activities	<u>(422,750)</u>	<u>(373,500)</u>
Increase (decrease) in cash	<u>113</u>	<u>(148)</u>

#### 17. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

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

Lakeview Hotel REIT's carrying value of accounts receivable, accounts payable and accrued liabilities and distributions payable approximates their fair value due to the immediate or short-term nature of these instruments.

The carrying value of the mortgages receivable approximates its fair value due to its recent advance.

The carrying value of the loan payable and mortgages payable approximates the fair value as interest rates are consistent with current rates.

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Based on trading value and other market factors, the estimated fair value of the debentures and the 10% and 9% convertible debentures approximates their carrying value and the estimated fair values of the 6.5% and 8.5% convertible debentures are \$8,101,000 and \$5,400,000, respectively.

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 these 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.

#### **Credit risk**

The amount of accounts receivable disclosed in the consolidated balance sheet of \$1,479,824 as at December 31, 2008 and \$2,030,665 as at December 31, 2007 is net of allowances for bad debts, estimated by management based on prior experience and their assessment of the current economic environment. No customer accounts for more than 10% of the accounts receivable balance.

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.

See note 4 for management's assessment of the credit risk relating to the mortgages receivable and the actions taken to mitigate it.

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#### Liquidity risk

Lakeview Hotel REIT's objective is to have sufficient liquidity to meet liabilities when due. Lakeview Hotel REIT monitors its cash balances and cash flows generated from operations to meet requirements. Lakeview Hotel REIT is in the final stages of completing the re-financing of the \$7,000,000 mortgage on the Days Inn - Ottawa Airport with long-term mortgages [note 11]. Included in current liabilities is a \$4,200,000 demand loan from Lakeview Hotel REIT's primary mortgage lender. While the loan is due on demand, there is currently no indication that repayment will be demanded in 2009. Subsequent to year end, The Trustees announced a suspension of monthly distributions to Unitholders following the February 2009 distribution in order to preserve capital.

Based on its 2009 cash flow forecast, and available financing, while there can be no assurance, management believes Lakeview Hotel REIT will be able to meet financial obligations as they come due.

#### 18. 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 income (loss) before income taxes as shown in the following table:

	2008	2007
	\$	\$
Income (loss) before income taxes	<b>(2,255,428)</b>	990,411
Temporary differences and non-tax deductible expenses	<b>2,255,428</b>	(155,248)
Earnings subject to tax in the hands of Unitholders/limited partners	—	(835,163)
Income subject to tax	—	—
Combined federal and provincial income tax at statutory rate of 35.41%	—	—
Income trust future tax (recovery)	<b>(734,000)</b>	734,000
Income tax provision (recovery)	<b>(734,000)</b>	734,000

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

	2008	2007
	\$	\$
Future tax assets		
Net taxable temporary difference	46,000	—
Valuation allowance	(46,000)	—
	—	—
Future tax liabilities		
Net taxable temporary difference	—	734,000

Due to new legislation enacted by the Government of Canada in June 2007 that imposed additional income taxes upon publicly traded income trusts effective January 1, 2011, Lakeview Hotel REIT recorded a one-time charge of \$734,000 to the future tax provision during 2007. The taxable temporary differences relate principally to the income properties and financing costs relating to long-term debt. Based on its assets and liabilities as at December 31, 2008, 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 \$164,000 net taxable temporary differences will reverse after January 1, 2011, resulting in a \$46,000 future income 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 or not that Lakeview Hotel REIT will realize the benefits of the future tax assets.

#### 19. 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 debt service coverage ratio covenants, 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 debt and/or issue or redeem units.

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Lakeview Hotel REIT monitors its capital by the following methods, including [but not limited to]:

- Maintaining a Corporate Debt Service Coverage ratio defined as earnings before interest, income taxes, depreciation and amortization [earnings base] to mortgage interest and principal payments [debt service] of no less than 1.10.
- Restricting the total of all mortgage loans on all income properties from being greater than 75% of the appraised value of the income properties in accordance with the Declaration of Trust. As at December 31, 2008 and 2007 respectively, the total of mortgage loans payable is 49.8% and 54.1% of the total estimated current value of income properties.

	2008	2007
	\$	\$
<b>Capital structure</b>		
Loan payable	4,200,000	—
Debentures	9,519,251	—
Convertible debentures	23,476,461	14,318,230
Mortgages payable	87,362,284	82,369,172
<b>Total debt</b>	<b>124,557,996</b>	<b>96,687,402</b>
Unitholders' equity	43,672,291	51,700,993
<b>Total capital</b>	<b>168,230,287</b>	<b>148,388,395</b>
	2008	2007
	\$	\$
<b>Debt service coverage ratio</b>		
Earnings base	12,999,290	10,562,275
Debt service	7,525,233	4,701,572
Debt service coverage ratio	<b>1.73</b>	<b>2.25</b>

Lakeview Hotel REIT is also subject to financial covenants in its mortgages payable, which are measured on an annual basis and include customary terms and conditions for borrowings of this nature. These include the Debt Service Coverage ratio presented above as well as FCCR for each individual hotel property pledged as security under the mortgages. As disclosed in note 11, Lakeview Hotel REIT was not in compliance with the FCCR requirements for six of the hotel properties as at December 31, 2008 and a forbearance agreement was obtained from the lender subsequent to year end.

## Lakeview Hotel Real Estate Investment Trust

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For the years ended December 31, 2008 and 2007, cash distributions to Unitholders exceeded Lakeview Hotel REIT's distributable income, as defined in the Declaration of Trust. Following the February 2009 distributions, monthly distributions were suspended.

#### 20. 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:

	\$
2009	38,129
2010	40,247
2011	42,365
2012	42,365
2013	42,365
Thereafter	1,376,863
	<u>1,582,334</u>

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

#### 21. COMPARATIVE FIGURES

Certain 2007 comparative figures have been reclassified to conform with the financial statement presentation adopted for 2008.