

FRONTENAC MORTGAGE INVESTMENT CORPORATION

FINANCIAL STATEMENTS

AS AT DECEMBER 31, 2011

FRONTENAC MORTGAGE INVESTMENT CORPORATION

DECEMBER 31, 2011

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Independent Auditor's Report

To the Shareholders of
Frontenac Mortgage Investment Corporation

We have audited the accompanying financial statements of Frontenac Mortgage Investment Corporation, which comprise the statement of investment portfolio as at December 31, 2011, the statement of net assets as at December 31, 2011 and 2010 and the statements of operations, changes in net assets and cash flows for the years then ended, and a summary of significant accounting policies and other explanatory information.

Management's responsibility for the financial statements

Management is responsible for the preparation and fair presentation of these 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 financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's responsibility

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 comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the 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 financial statements.

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

Opinion

In our opinion, the financial statements present fairly, in all material respects, the statement of investment portfolio as at December 31, 2011, the financial position of Frontenac Mortgage Investment Corporation as at December 31, 2011 and 2010 and the results of its operations, changes in net assets and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Raymond Chabot Grant Thornton LLP

Chartered Accountants,
Licensed Public Accountants

Ottawa, Ontario
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FRONTENAC MORTGAGE INVESTMENT CORPORATION

STATEMENT OF NET ASSETS

AS AT DECEMBER 31, 2011

	<u>2011</u>	<u>2010</u>
ASSETS		
Cash and cash equivalents	\$ 1,254,128	\$ 1,279,227
Mortgage investments (Note 5)	44,925,909	31,067,014
Prepaid expenses	<u>8,517</u>	<u>8,517</u>
	<u>46,188,554</u>	<u>32,354,758</u>
LIABILITIES		
Bank line of credit (Note 6)	\$ -	\$ 1,300,000
Dividends payable	50,189	7,364
Accounts payable and accrued expenses	56,238	62,351
Prepaid mortgage payments	<u>33,810</u>	<u>11,667</u>
	<u>140,237</u>	<u>1,381,382</u>
NET ASSETS REPRESENTING SHAREHOLDERS' EQUITY	<u>\$ 46,048,317</u>	<u>\$ 30,973,376</u>
NET ASSETS PER SHARE	<u>\$ 30.00</u>	<u>\$ 30.00</u>

APPROVED ON BEHALF OF THE BOARD:

___ *Colleen Allison* (signed) _____ Director

___ *Margaret Kelk* (signed) _____ Director

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

FRONTENAC MORTGAGE INVESTMENT CORPORATION

STATEMENT OF OPERATIONS

FOR THE YEAR ENDED DECEMBER 31, 2011

	<u>2011</u>	<u>2010</u>
INTEREST INCOME	\$ <u>3,771,220</u>	\$ <u>2,851,989</u>
EXPENSES		
Administration fees (Note 8)	800,627	639,149
Audit fees	39,180	26,943
Director fees	36,417	40,567
General and operating expenses	239,863	212,508
Interest and bank charges	39,361	3,788
Legal fees	32,077	48,249
Custodian fees	11,300	10,500
Trustee account fees	<u>63,896</u>	<u>88,904</u>
	<u>1,262,721</u>	<u>1,070,608</u>
NET INVESTMENT INCOME	2,508,499	1,781,381
Realized losses on mortgage investments	(271,336)	(326,119)
Unrealized change in fair value of mortgage investments	<u>151,000</u>	<u>15,000</u>
INCREASE IN NET ASSETS FROM OPERATIONS	\$ <u>2,388,163</u>	\$ <u>1,470,262</u>
WEIGHTED AVERAGE NUMBER OF SHARES ISSUED AND OUTSTANDING	<u>1,224,699</u>	<u>993,420</u>
INCREASE IN NET ASSETS FROM OPERATIONS PER SHARE	\$ <u>1.95</u>	\$ <u>1.48</u>

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

FRONTENAC MORTGAGE INVESTMENT CORPORATION

STATEMENT OF CHANGES IN NET ASSETS

FOR THE YEAR ENDED DECEMBER 31, 2011

	<u>2011</u>	<u>2010</u>
NET ASSETS, beginning of year	\$ <u>30,973,376</u>	\$ <u>28,152,846</u>
Increase in net assets from operations	<u>2,388,163</u>	<u>1,470,262</u>
Share capital transactions		
Proceeds from issuance of shares for cash	13,997,592	2,929,163
Reinvested dividends	2,170,541	1,425,783
Cost of shares redeemed	<u>(1,093,192)</u>	<u>(1,534,416)</u>
	<u>15,074,941</u>	<u>2,820,530</u>
Distributions to shareholders		
Dividends to shareholders	<u>(2,388,163)</u>	<u>(1,470,262)</u>
NET ASSETS, end of year	\$ <u>46,048,317</u>	\$ <u>30,973,376</u>

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

FRONTENAC MORTGAGE INVESTMENT CORPORATION

STATEMENT OF CASH FLOWS

FOR THE YEAR ENDED DECEMBER 31, 2011

	<u>2011</u>	<u>2010</u>
CASH FROM OPERATING ACTIVITIES		
Net investment income	\$ 2,508,499	\$ 1,781,381
Net changes in non-cash working capital balances:		
Decrease in accounts receivable	-	66,030
(Increase) in prepaid expenses	-	(1,327)
Increase in dividends payable	42,826	7,364
(Decrease) increase in accounts payable and accrued expenses	<u>(6,113)</u>	<u>31,431</u>
NET CASH PROVIDED BY OPERATING ACTIVITIES	<u>2,545,212</u>	<u>1,884,879</u>
FINANCING ACTIVITIES		
Increase (decrease) in bank line of credit	(1,300,000)	1,035,000
Proceeds from issuance of shares for cash	13,997,592	2,929,163
Cash dividends	(217,622)	(44,478)
Redemption of common shares	<u>(1,093,192)</u>	<u>(1,534,416)</u>
NET CASH PROVIDED BY FINANCING ACTIVITIES	<u>11,386,778</u>	<u>2,385,269</u>
INVESTING ACTIVITIES		
Increase (decrease) in prepaid mortgage payments	22,143	(111,448)
New mortgage investments	(36,574,028)	(23,871,668)
Repayment of mortgage investments	<u>22,594,796</u>	<u>20,735,305</u>
NET CASH USED IN INVESTING ACTIVITIES	<u>(13,957,089)</u>	<u>(3,247,811)</u>
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(25,099)	1,022,337
CASH AND CASH EQUIVALENTS, beginning of year	<u>1,279,227</u>	<u>256,890</u>
CASH AND CASH EQUIVALENTS, end of year	<u>\$ 1,254,128</u>	<u>\$ 1,279,227</u>

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

FRONTENAC MORTGAGE INVESTMENT CORPORATION

STATEMENT OF INVESTMENT PORTFOLIO

AS AT DECEMBER 31, 2011

	Principal Value	Amortized Cost	Fair Value
MORTGAGES 97.56%	<u>45,141,909</u>	<u>44,925,909</u>	44,925,909
CASH AND OTHER NET ASSETS 2.44%			1,122,408
NET ASSETS 100%			\$ <u>46,048,317</u>

DISTRIBUTION OF MORTGAGE INVESTMENTS

	Interest Rates	Number of mortgages	Amortized Cost	Fair Value
Mortgages are 77% residential and 23% commercial. All mortgages are pre-payable, uninsured conventional mortgages with terms to maturity ranging from 1 to 2 years.	8%	2	\$ 95,417	\$ 95,417
	9%	19	6,620,662	6,620,662
	10%	67	16,325,914	16,325,914
	11%	30	5,481,856	5,481,856
	12%	84	16,353,882	16,353,882
	13%	<u>1</u>	<u>48,178</u>	<u>48,178</u>
		<u>203</u>	<u>\$ 44,925,909</u>	<u>\$ 44,925,909</u>

The accompanying notes form an integral part of these financial statements

FRONTENAC MORTGAGE INVESTMENT CORPORATION

NOTES TO THE FINANCIAL STATEMENTS

FOR THE YEAR ENDED DECEMBER 31, 2011

1. DESCRIPTION OF THE BUSINESS

Frontenac Mortgage Investment Corporation (the "Company") was incorporated on October 26, 2004 pursuant to the *Canada Business Corporations Act*. The Company's objective is to generate income while preserving, for its beneficial shareholders, capital for re-investment. As a mortgage investment corporation, the Company expects to derive its earnings principally from the receipt of mortgage interest payments and of interest or interest-like distributions on the cash reserves of the Company.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

These financial statements have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP") and with National Instrument 81-106 on continuous disclosure pre-changeover to International Financial Reporting Standards ("IFRS").

(a) Revenue recognition

Interest income on mortgages and other investment income are recognized on the accrual basis in the period earned. Interest is not accrued on mortgages that are identified as impaired.

(b) Use of estimates

The preparation of financial statements in accordance with generally accepted accounting principles requires management to make assumptions and estimates that affect the reported amounts of assets and liabilities at the date of the financial statements, the reported amounts of revenue and expenses for the year, as well as the disclosure of contingent assets and liabilities at the date of the financial statements. Actual amounts could differ from these estimates. Significant estimates include the fair value of the Company's mortgages and are subject to measurement uncertainty. Changes in estimates are recorded in the accounting period in which they are determined.

(c) Mortgage investments

Mortgage investments are stated at fair value in accordance with CICA Accounting Guideline 18 ("AcG-18"). Any unrealized changes in the fair value of an investment are recorded in the statement of operations for the period. The fair value of mortgage investments is determined by discounting future cash flow at the Company's prevailing rate of return on new mortgages of similar type, term, and credit risk.

(d) Income taxes

The Company is considered a mortgage investment corporation under the *Income Tax Act* (Canada). The Company distributes all of its net income to its shareholders in the form of dividends in order not to be subject to income taxes.

(e) Net assets per share

Net assets per share is calculated by dividing the net assets by the total number of issued and outstanding common shares at the end of the year.

FRONTENAC MORTGAGE INVESTMENT CORPORATION

NOTES TO THE FINANCIAL STATEMENTS (Continued)

FOR THE YEAR ENDED DECEMBER 31, 2011

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

(f) Prepaid mortgage payments

Some mortgagors may prepay or may be required to prepay a portion of their periodic payments. These prepaid mortgage payments are applied against the related mortgage receivable balance in the period for which they relate.

(g) Financial instruments

The Company's most significant financial instruments consist of its mortgage investments. In accordance with AcG-18, mortgage investments are required to be recorded at fair value as defined in CICA Handbook Section 3855, "Financial Instruments - Recognition and Measurement". Mortgage investments are valued on the policies described in paragraph (c) above. The financial risks associated with the Company's mortgage investments and the Company's management of those risks are discussed in Note 5.

The Company's other financial instruments consist of cash and cash equivalents, bank line of credit, accounts payable and accrued expenses, and dividends payable. Unless otherwise noted, it is management's opinion that the Company is not exposed to significant interest or currency risks arising from these financial instruments. The fair value of these financial instruments approximate their carrying value, unless otherwise noted.

In accordance with Canadian GAAP, the Company is required to classify its financial assets as one of the following: held-to-maturity, loans and receivables, held-for-trading or available for sale. Financial liabilities must be classified as: held-for-trading or other liabilities. The Company has designated its financial assets and financial liabilities as follows:

(i) Financial assets:

Cash and cash equivalents are classified as held-for-trading and recorded at fair value.

(ii) Financial liabilities:

Bank line of credit, accounts payable and accrued expenses, and dividends payable are classified as other liabilities and recorded at amortized cost.

3. CAPITAL STRUCTURE AND FINANCIAL POLICIES

The Company's definition of capital includes net assets and bank line of credit.

The Company's objective when managing its capital is to generate income while preserving, for its beneficial shareholders, capital for re-investment. As a mortgage investment corporation, the Company expects to derive its earnings principally from the receipt of mortgage interest payments and of interest or interest-like distributions on the cash reserves of the Company.

The Company achieves its investment objective by lending on the security of mortgages on real properties situated in Canada, primarily in Eastern Ontario. The mortgages transacted by the Company will not generally meet the underwriting criteria of conventional lenders and/or involve borrowers in rural areas generally not well serviced by major lenders. As a result, the Company's investments are expected to earn a higher rate of interest than what is generally obtainable through conventional mortgage lending activities.

FRONTENAC MORTGAGE INVESTMENT CORPORATION

NOTES TO THE FINANCIAL STATEMENTS (Continued)

FOR THE YEAR ENDED DECEMBER 31, 2011

3. CAPITAL STRUCTURE AND FINANCIAL POLICIES (Continued)

In order to provide some liquidity to its shareholders, the Company is required to maintain approximately 5% of its net assets in cash or near cash assets and such levels of cash reserves have been adequate to meet the needs of normal share redemption levels during the year. Management regularly monitors its available cash and credit line facility to ensure that the 5% cash reserve is maintained. As at December 31, 2011 and 2010, the Company has maintained the 5% cash reserve. For unusual circumstances, the Company has redemption policies in place to restrict the payout of share redemption at levels to match the normal repayment of the mortgages receivable.

The Company's capital management objectives and strategies are unchanged from prior years.

4. FINANCIAL INSTRUMENTS

In accordance with Canadian GAAP, the Company must classify fair value measurements using a fair value hierarchy that reflects the significance of the inputs used in making its fair value measurements. The following hierarchy has been used in determining and disclosing fair value of financial instruments:

Level 1: quoted prices in active markets for the same instrument (i.e. without modification or repackaging);

Level 2: quoted prices in active markets for similar assets or liabilities or other valuation techniques for which all significant inputs are based on observable market data; and

Level 3: valuation techniques for which any significant input is not based on observable market data.

The Company's cash and cash equivalents are valued using Level 1 measures and the mortgage investments are valued using Level 3 measures. Mortgage investments are valued using Level 3 measures as there are no quoted prices in an active market for the Company's mortgages. As explained in more detail in Note 5, management makes its determination of fair value for its mortgage investments based on its assessment of the current mortgage market for mortgages of same or similar terms.

5. MORTGAGE INVESTMENTS

There are 203 mortgages (2010 - 152) held which are a combination of mainly first and second mortgages secured by residential and commercial property.

Credit risk

Credit risk arises from the possibility that mortgagors may experience financial difficulty and be unable to fulfil their mortgage commitments. The Company mitigates this risk by having well established lending policies in place that ensure mortgages are well secured and by limiting its exposure to any one mortgagor. There are no significant concentrations of credit risk as the average mortgage amount as at December 31, 2011 was \$219,215 (2010 - \$205,532) and the largest mortgage was \$2,611,173 (2010 - \$2,014,800). As at December 31, 2011, there are 10 mortgages totaling \$2,862,240 (2010 - 11 mortgages totaling \$1,762,896) that considered are past due by management.

FRONTENAC MORTGAGE INVESTMENT CORPORATION
NOTES TO THE FINANCIAL STATEMENTS (Continued)

FOR THE YEAR ENDED DECEMBER 31, 2011

5. MORTGAGE INVESTMENTS (Continued)

Interest rate price risk

Interest rate price risk arises from the possibility that at the end of a mortgage's term it will be re-priced to a prevailing interest rate lower than the original one. This risk is mitigated by the fact that the Company is not as exposed to market mortgage rates because there is no specific market for mortgages of similar type, term and credit risk. This has allowed the Company to renew its mortgages at consistent rates.

Mortgages are issued with either 1 or 2 year terms, have fixed interest rates and can be paid in full before maturity without penalty. The weighted average interest rate of the mortgages as at December 31, 2011 was 10.80% (2010 - 10.82%).

A 50 basis point increase or decrease in interest rates, with all other variables held constant, will not effect an increase or decrease in net investment income as the Company's mortgage investments are issued at fixed interest rates.

Fair values

Fair value is the amount of consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties under no compulsion to act. As there are no quoted prices in an active market for the Company's mortgages, management makes its determination of fair value based on its assessment of the current mortgage market for mortgages of same or similar terms. As the Company and its borrowers are unrelated third parties under no compulsion to act, the initial terms of the mortgage represents their fair value at the time of mortgage origination. When collection of principal on a particular mortgage investment is no longer reasonably assured, the fair value of the mortgage is reduced to reflect the estimated net realizable recovery from the collateral securing the loan.

The following table shows a reconciliation of the opening and closing balance of fair value of mortgage investments:

	2011	2010
Mortgage investments - beginning of year	\$ 31,067,014	\$ 28,241,771
Realized losses	(271,336)	(326,119)
Unrealized change in fair value	151,000	15,000
Net advances and repayments	<u>13,979,231</u>	<u>3,136,362</u>
Mortgage investments - end of year	<u>44,925,909</u>	<u>31,067,014</u>

Liquidity risk

Liquidity risk is the risk that the Company will not be able to meet its financial obligations and commitments as they fall due. The Company's approach is to ensure that it will have sufficient cash and credit facilities to meet its liabilities when due, under normal and stressed circumstances. As at December 31, 2011, the Company's liabilities consisted of accounts payable and accrued expenses totaling \$56,238 all of which are due within normal trade terms of generally 30 days. The Company maintains significant committed borrowing facilities from its bank for credit room at approximately equal to ten percent of net assets. In addition, the Company has policies in place that can restrict the total amount of share redemptions. Those restrictions permit share redemptions to be funded through the normal repayment of the mortgages receivable.

FRONTENAC MORTGAGE INVESTMENT CORPORATION

NOTES TO THE FINANCIAL STATEMENTS (Continued)

FOR THE YEAR ENDED DECEMBER 31, 2011

6. BANK LINE OF CREDIT

The Company has established a revolving line of credit with a major Canadian chartered bank and, in August 2011, the limit of this line of credit was increased from \$3,000,000 to \$4,500,000. The line of credit is secured by a General Security Agreement and a first ranking interest in the mortgages and is repayable on demand. The availability of funds may be cancelled or restricted by the bank at any time. The credit facility bears interest at bank prime rate of 3.00% (2010 - 3.00%) plus 1%.

Financial covenants require the Company to maintain a minimum levels for equity, debt to equity ratio, and percentage of residential mortgages. As at December 31, 2011 the Company was in compliance with the bank's financial covenants.

7. CAPITAL STOCK

Authorized capital:

The authorized capital consists of an unlimited number of voting, non-cumulative common shares.

Changes during the year:

	2011		2010	
	Number of shares issued	\$	Number of shares issued	\$
Balance, beginning of year	1,032,446	30,973,376	938,428	28,152,846
Issued for cash	466,586	13,997,592	97,639	2,929,163
Issued through dividend reinvestment plan	72,351	2,170,541	47,526	1,425,783
Redeemed for cash	<u>(36,440)</u>	<u>(1,093,192)</u>	<u>(51,147)</u>	<u>(1,534,416)</u>
Balance, end of year	<u>1,534,943</u>	<u>46,048,317</u>	<u>1,032,446</u>	<u>30,973,376</u>

Dividend reinvestment plan and direct share purchase plan

Unless a shareholder elects to receive their dividends as cash, the dividends issued to shareholders are automatically reinvested in the Company by the direct purchase of shares at the current market price.

Redemptions

Shareholders may only redeem common shares once per year, on November 30, except in certain unusual circumstances. During the year the Company redeemed for cash 36,440 common shares at the price of \$30.00 per share for total proceeds of \$1,093,192. For the year ended December 31, 2010, 51,147 common shares were redeemed for cash at the price of \$30.00 per share for total proceeds of \$1,534,416.

8. RELATED PARTIES

Pillar Financial Services Inc. ("Pillar") is the administrator for the Company. Its responsibilities include originating loan transactions, underwriting the mortgages, collecting mortgage payments, and the internal audit and accounting for the Company.

W.A. Robinson & Associates Ltd. ("W.A.") provides portfolio management advice and investment counsel and acts as share registrar and transfer agent for the Company.

The companies are related in that they share common management. Pillar and W.A. each charge an annual fee of 1% of the total asset value calculated on a monthly basis. Total fees paid to Pillar for the year ended December 31, 2011 were \$375,881 (2010 - \$305,695) and the total fees paid to W.A. for the year ended December 31, 2011 were \$424,746 (2010 - \$333,454) under these contracts. These transactions are in the normal course of operations and are measured at the exchange amount which is the amount of consideration established and agreed to by the parties.

FRONTENAC MORTGAGE INVESTMENT CORPORATION

NOTES TO THE FINANCIAL STATEMENTS (Continued)

FOR THE YEAR ENDED DECEMBER 31, 2011

9. RECONCILIATION OF NET ASSETS TO NET ASSET VALUE

In accordance with Canadian securities legislation, a reconciliation is required of any difference between net assets, calculated in accordance with Canadian GAAP, and net asset value. As at December 31, 2011 and as at December 31, 2010, as the Company's net assets are presented at fair value in accordance with Canadian GAAP for investment companies, there was no difference between the net assets and the net asset value.