# DIAMOND ESTATES WINES & SPIRITS INC.

## INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

## THREE AND NINE MONTH PERIODS ENDED DECEMBER 31, 2014 AND 2013

**(Unaudited - Prepared by Management)**

**(These unaudited interim condensed consolidated financial statements, prepared by management, have not been reviewed by the company's external auditors)**

# DIAMOND ESTATES WINES & SPIRITS INC.
## INTERIM CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL POSITION
## AS AT DECEMBER 31, 2014 AND MARCH 31, 2014
## (Unaudited - Prepared by Management)

| | **December 31 2014** | March 31 2014 |
|---|---|---|
| **ASSETS** | | |
| **Current:** | | |
| Accounts receivable (Note 7) | **$ 4,225,443** | $ 3,035,264 |
| Inventories (Note 8) | **16,983,744** | 12,466,162 |
| Prepaid expenses | **102,884** | 139,222 |
| Assets held for sale (Notes 6 & 9) | **-** | 1,880,916 |
| | **21,312,071** | 17,521,564 |
| **Long term:** | | |
| Biological assets | **86,030** | 86,030 |
| Property, plant and equipment | **15,535,491** | 15,992,766 |
| Intangible assets and goodwill (Note 5) | **4,257,922** | 758,647 |
| | **$ 41,191,514** | $ 34,359,007 |
| **LIABILITIES** | | |
| **Current:** | | |
| Bank indebtedness (Note 10) | **$ 12,274,083** | $ 12,175,284 |
| Bank indebtedness associated with assets held for sale (Notes 9 & 10) | **-** | 837,845 |
| Accounts payable and accrued liabilities (Note 11) | **5,199,489** | 3,319,935 |
| Government remittances payable | **515,452** | 141,654 |
| Deposits received | **11,750** | 39,050 |
| Shareholder loan payable (Note 12) | **500,000** | 500,000 |
| Current portion of term loan payable (Note 13) | **692,894** | 616,115 |
| Note payable - non-controlling interest (Note 14) | **3,057,914** | - |
| | **22,251,582** | 17,629,883 |
| **Long term:** | | |
| Term loan payable (Note 13) | **8,729,644** | 9,212,401 |
| | **30,981,226** | 26,842,284 |
| **SHAREHOLDERS' EQUITY** | | |
| Common shares | **39,578,798** | 39,578,798 |
| Contributed surplus | **154,620** | 154,620 |
| Reserve for warrants | **128,863** | 128,863 |
| Reserve for share based payments (Note 16) | **390,834** | 254,554 |
| Non-controlling interest (Note 5) | **3,262,565** | - |
| Accumulated deficit | **(33,305,392)** | (32,600,112) |
| | **10,210,288** | 7,516,723 |
| | **$ 41,191,514** | $ 34,359,007 |

**Going concern** (Note 1(b))

**Contingency** (Note 19)

**Subsequent events** (Note 21)

*The accompanying notes form an integral part of these unaudited interim condensed consolidated financial statements*

**Approved on behalf of the Board:**

*"David Beutel"* Director *"Keith Harris"* Director

# DIAMOND ESTATES WINES & SPIRITS INC.
## INTERIM CONDENSED CONSOLIDATED STATEMENTS OF NET LOSS AND COMPREHENSIVE LOSS
## THREE AND NINE MONTH PERIODS ENDED DECEMBER 31, 2014 AND 2013
## (Unaudited - Prepared by Management)

| | **Three months ended December 31 2014** | **Nine months ended December 31 2014** | Three months ended December 31 2013 | Nine months ended December 31 2013 |
|---|---|---|---|---|
| **Revenue** | **$ 7,877,312** | **$ 18,907,188** | $ 5,412,780 | $ 16,637,566 |
| **Expenses** | | | | |
| Change in inventories of finished goods and raw materials consumed | **4,152,591** | **9,530,869** | 2,820,128 | 8,859,199 |
| Employee compensation and benefits | **1,612,168** | **3,550,317** | 906,293 | 3,090,470 |
| Advertising and promotion | **561,017** | **1,764,099** | 656,023 | 1,807,042 |
| General and administrative | **801,963** | **1,786,788** | 517,285 | 1,499,256 |
| Interest on bank indebtedness | **358,746** | **1,048,893** | 338,421 | 1,258,545 |
| Freight and warehousing | **392,281** | **731,943** | 235,661 | 596,438 |
| Bad debts | **4,628** | **30,147** | 29,812 | 279,834 |
| Financing costs | **7,378** | **21,062** | 61,849 | 422,612 |
| Depreciation of property, plant and equipment | **228,385** | **678,745** | 270,590 | 808,071 |
| Share based payments | **49,613** | **136,280** | - | 190,666 |
| Amortization of intangible assets | **451** | **1,316** | 87,200 | 261,600 |
| | **8,169,221** | **19,280,459** | 5,923,262 | 19,073,733 |
| **Loss from operations before undernoted items** | **(291,909)** | **(373,271)** | (510,482) | (2,436,167) |
| Loss on disposal - assets held for sale | **80,916** | **80,916** | - | - |
| Non-cash loss on completion of reverse takeover | **-** | **-** | - | 749,787 |
| Restructuring charges | **488,528** | **488,528** | 78,648 | 78,648 |
| Share price guarantees | **-** | - | - | (247,332) |
| Listing expenses | **-** | **-** | - | 342,405 |
| **Net loss and comprehensive loss** | **$ (861,353)** | **$ (942,715)** | $ (589,130) | $ (3,359,675) |
| **Net loss and comprehensive loss attributable to:** | | | | |
| Shareholders | **$ (623,918)** | **$ (705,280)** | $ (589,130) | $ (3,359,675) |
| Non-controlling interest | **(237,435)** | **(237,435)** | - | - |
| | **$ (861,353)** | **$ (942,715)** | $ (589,130) | $ (3,359,675) |
| **Loss per share - basic and diluted** (Note 12) | **$ (0.012)** | **$ (0.013)** | $ (0.008) | $ (0.093) |

*The accompanying notes form an integral part of these unaudited interim condensed consolidated financial statements*

# DIAMOND ESTATES WINES & SPIRITS INC.
## INTERIM CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
## PERIOD FROM APRIL 1, 2013 TO DECEMBER 31, 2014
## (Unaudited - Prepared by Management)

| | Common shares | | Preference shares | | Reserve for warrants | Shares to be issued | Share based payments | Contributed surplus | Accumulated deficit | Shareholders' equity | Non-controlling interest | Total |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Shares | Amount | Shares | Amount | | | | | | | | |
| **As at April 1, 2013** | **14,999,716** | **$ 26,991,074** | **4,431,386** | **$ 2,065,441** | **$ 128,863** | **$ 129,699** | **$ 154,620** | **$ -** | **$ (28,433,614)** | **$ 1,036,083** | **$ -** | **$ 1,036,083** |
| Share price guarantees | 4,346,659 | 869,332 | - | - | - | - | - | - | - | 869,332 | - | 869,332 |
| Convertible debentures | 1,787,278 | 357,456 | - | - | - | - | - | - | - | 357,456 | - | 357,456 |
| Preference shares converted | 4,431,386 | 2,065,441 | (4,431,386) | (2,065,441) | - | - | - | - | - | - | - | - |
| Payment of 8% dividend | 361,310 | 216,787 | - | - | - | (216,787) | - | - | - | - | - | - |
| Accounts payable settled | 377,192 | 76,850 | - | - | - | - | - | - | - | 76,850 | - | 76,850 |
| Shares and options deemed issued in connection with RTO | 5,324,000 | 1,064,800 | - | - | - | - | 63,888 | - | - | 1,128,688 | - | 1,128,688 |
| Elimination of Diamond shares | (26,275,310) | (5,255,062) | - | - | - | - | - | - | - | (5,255,062) | - | (5,255,062) |
| Shares issued to Diamond shareholders under RTO | 26,275,310 | 5,255,062 | - | - | - | - | - | - | - | 5,255,062 | - | 5,255,062 |
| Private placement | 41,756,060 | 8,351,212 | - | - | - | - | - | - | - | 8,351,212 | - | 8,351,212 |
| Share issue costs | - | (385,125) | - | - | - | - | - | - | - | (385,125) | - | (385,125) |
| Preference share dividends | - | - | - | - | - | 87,088 | - | - | (87,088) | - | - | - |
| Share based payments | - | - | - | - | - | - | 190,666 | - | - | 190,666 | - | 190,666 |
| Options cancelled | - | - | - | - | - | - | (154,620) | 154,620 | - | - | - | - |
| Net loss and comprehensive loss | - | - | - | - | - | - | - | - | (3,359,675) | (3,359,675) | - | (3,359,675) |
| **As at December 31, 2013** | **73,383,601** | **39,607,827** | **-** | **-** | **128,863** | **-** | **254,554** | **154,620** | **(31,880,377)** | **8,265,487** | **-** | **8,265,487** |
| Convertible debentures | - | (35,746) | - | - | - | - | - | - | - | (35,746) | - | (35,746) |
| Payment of 8% dividend | 6,663 | 3,996 | - | - | - | (3,996) | - | - | - | - | - | - |
| Accounts payable settled | 13,485 | 2,721 | - | - | - | - | - | - | - | 2,721 | - | 2,721 |
| Preference share dividends | - | - | - | - | - | 3,996 | - | - | (3,996) | - | - | - |
| Net loss and comprehensive loss | - | - | - | - | - | - | - | - | (715,739) | (715,739) | - | (715,739) |
| **As at March 31, 2014** | 73,403,749 | 39,578,798 | - | - | 128,863 | - | 254,554 | 154,620 | (32,600,112) | 7,516,723 | - | 7,516,723 |
| Acquisition of partnership interest *(note 5)* | - | - | - | - | - | - | - | - | - | - | 3,500,000 | 3,500,000 |
| Net loss and comprehensive loss | - | - | - | - | - | - | - | - | (705,280) | (705,280) | (237,435) | (942,715) |
| Share based payments | - | - | - | - | - | - | 136,280 | - | - | 136,280 | - | 136,280 |
| **As at December 31, 2014** | **73,403,749** | **$ 39,578,798** | **-** | **$ -** | **$ 128,863** | **$ -** | **$ 390,834** | **$ 154,620** | **$ (33,305,392)** | **$ 6,947,723** | **$ 3,262,565** | **$ 10,210,288** |

*The accompanying notes form an integral part of these unaudited interim condensed consolidated financial statements*

# DIAMOND ESTATES WINES & SPIRITS INC.
## INTERIM CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
## NINE MONTH PERIODS ENDED DECEMBER 31, 2014 AND 2013
## (Unaudited - Prepared by Management)

| | **2014** | 2013 |
|---|---|---|
| **Operating activities** | | |
| **Net loss** | **$ (942,715)** | $ (3,359,675) |
| Add (deduct) items not affecting cash | | |
| Depreciation of property, plant and equipment | **678,745** | 808,071 |
| Amortization of intangible assets | **1,316** | 261,600 |
| Loss on sale of property, plant and equipment | **5,363** | 1,725 |
| Gain on settlement of share price guarantees | **-** | (247,332) |
| Share based payments | **136,280** | 190,666 |
| Non-cash loss on completion of reverse takeover | **-** | 749,787 |
| Non-cash financing costs | **-** | 51,606 |
| Loss on disposition - assets held for sale (Note 9) | **80,916** | - |
| | **(40,095)** | (1,543,552) |
| **Change in non-cash working capital items** | | |
| Accounts receivable | **325,024** | 242,233 |
| Inventory | **(1,484,318)** | (1,179,503) |
| Prepaid expenses | **36,338** | 24,258 |
| Accounts payable and accrued liabilities | **389,001** | 611,206 |
| Government remittances payable | **373,798** | (52,097) |
| Deposits received | **(27,300)** | (14,649) |
| | **(427,552)** | (1,912,104) |
| **Investing activities** | | |
| Purchase of property, plant and equipment | **(227,424)** | (52,236) |
| Proceeds on disposition of assets held for sale | **1,800,000** | - |
| | **1,572,576** | (52,236) |
| **Financing activities** | | |
| Term loan payable | **(405,978)** | 10,000,000 |
| Bank indebtedness | **98,799** | (16,258,641) |
| Bank indebtedness associated with assets for sale | **(837,845)** | - |
| Payment against share price guarantee | **-** | (184,000) |
| Share issue costs | **-** | (385,125) |
| Cash acquired in reverse takeover | **-** | 440,894 |
| Proceeds from issuance of common shares | **-** | 8,351,212 |
| | **(1,145,024)** | 1,964,340 |
| **Change in cash** | **-** | - |
| Cash, beginning of period | **-** | - |
| **Cash, end of period** | **$ -** | $ - |

*The accompanying notes form an integral part of these unaudited interim condensed consolidated financial statements*

### 1. NATURE OF OPERATIONS AND GOING CONCERN

#### (a) Nature of operations

Diamond Estates Wines & Spirits Inc. ("Diamond" or the "Company") (formerly Whiteknight Acquisitions II Inc.) ("WKN") was a Capital Pool Company as defined in the policies of the TSX Venture Exchange ("TSX-V" or the "Exchange") and was incorporated pursuant to the provisions of the Business Corporations Act of Ontario on December 31, 2011. On September 24, 2013, the Company completed a Qualifying Transaction as defined in the policies of the Exchange when it acquired 100% of the issued and outstanding shares of Diamond Estates Wines & Spirits Ltd. ("Diamond Ltd."). The transaction constituted a reverse takeover of WKN by Diamond Ltd. as more fully described in note 4. The Company reconstituted its board of directors and senior management team at that time and changed its name to Diamond Estates Wines & Spirits Inc.

The Company's common shares are listed on the TSX-V under the symbol "DWS.V".

The principal business activities of the Company include the operation and consolidation of wineries, wine, spirit, and beer distribution agencies, and sales and brand development. The address of the Company's registered office and principal place of business is 1067 Niagara Stone Road, Niagara-On-The-Lake, Ontario, L0S 1J0.

#### (b) Going concern

The accompanying unaudited interim condensed consolidated financial statements have been prepared using International Financial Reporting Standards ("IFRS") (as issued by the International Accounting Standard Board ("IASB")) applicable to a going concern. Accordingly, they do not give effect to adjustments that would be necessary should the Company be unable to continue as a going concern and, therefore, be required to realize its assets and liquidate its liabilities and commitments in other than the normal course of business and at amounts different from those in the accompanying unaudited interim condensed consolidated financial statements. Such adjustments could be material.

The Company has incurred repeated losses as net loss and comprehensive loss for the nine month period ended December 31, 2014 was $942,715 (December 31, 2013 - $3,359,675) with an accumulated deficit as at December 31, 2014 of $33,305,392 (March 31, 2014 - $32,600,112). Working capital deficiency as at December 31, 2014 was $939,511 compared with $108,319 as at March 31, 2014.

The Company's ongoing losses, nominal working capital for the winery division, narrow margins and tight covenant measurements under the terms of the credit agreement with its lender *(see note 10)* indicate the existence of material uncertainties that may cast significant doubt on its ability to continue as a going concern.

## 2. SIGNIFICANT ACCOUNTING POLICIES

### (a) Statement of compliance

These unaudited interim condensed consolidated financial statements have been prepared in accordance with IAS 34 "Interim Financial Reporting" as issued by the IASB, and accordingly do not include all the information required for full annual financial statements by IFRS. They have been prepared using the same accounting policies that were described in note 2 to the Company's annual consolidated financial statements for the year ended March 31, 2014.

The unaudited interim condensed consolidated financial statements have not been reviewed by the Company's external auditors. They were authorized for issuance by the Board of Directors on February 18, 2015.

### (b) Basis of consolidation

These consolidated financial statements include the accounts of the Company and its subsidiaries:

| | | |
|---|---|---|
| ♦ | Diamond Estates Wines & Spirits Ltd. *(see note 4)* | 100% |
| ♦ | Niagara Cellars Ltd. (o/a Diamond Estates - The Winery) | 100% |
| ♦ | De Sousa Wines Toronto Inc. | 100% |
| ♦ | De Sousa Wine Cellars Corporation *(see note 6)* | 100% |
| ♦ | Kirkwood Diamond Canada (partnership) *(see note 5)* | 50.01% |

A subsidiary is an entity controlled by the Company. Control exists when the Company has power over an investee, is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to use its power over the investee to affect its returns. The financial statements of a subsidiary are included in the consolidated financial statements from the date that control commences until the date that control ceases. The accounting policies of subsidiaries are changed when necessary to align them with the policies applied by the Company in these consolidated financial statements. All intercompany balances, income and expenses, and unrealized gains and losses resulting from intercompany transactions are eliminated in full.

## 3. NEW AND REVISED IFRS STANDARDS AND INTERPRETATIONS NOT YET ADOPTED

As at the date of authorization of these unaudited interim condensed consolidated financial statements, the IASB has issued the following new or revised standards which are not yet effective:

(a) **IFRS 9: "Financial Instruments"** was issued by the IASB on November 12, 2009 and will replace IAS 39 "Financial Instruments: Recognition and Measurement". IFRS 9 replaces the multiple rules in IAS 39 with a single approach to determine whether a financial asset is measured at amortized cost or fair value and a new mixed measurement model for debt instruments having only two categories: amortized cost and fair value. The approach in IFRS 9 is based on how an entity manages its financial instruments in the context of its business model and the contractual cash flow characteristics of the financial assets. The new standard also requires a single impairment method to be used, replacing the multiple impairment methods in IAS 39. IFRS 9 is effective for annual periods beginning on or after January 1, 2018.

(b) **IFRS 15: “Revenue from Contracts with Customers”** provides new requirements for recognizing revenue. The new standard's core principle is for a company to recognize revenue to depict the transfer of goods or services to customers in amounts that reflect the consideration to which the company expects to be entitled in exchange for those goods or services. The new standard sets out enhanced disclosures about revenue, provides guidance for transactions that were not previously addressed comprehensively and improves guidance for multiple-element arrangements. IFRS 15 is effective for annual periods beginning on or after January 1, 2017.

(c) **IAS 32: "Financial Instruments - Offsetting Financial Assets and Financial Liabilities"** provides further clarification on the application of the offsetting requirements. The Company will start the application of IAS 32 in the financial statements effective from March 31, 2015.

The Company has not early adopted any of these standards, but management is currently assessing the impact of their application in the unaudited interim condensed consolidated financial statements.

## 4. REVERSE TAKEOVER TRANSACTION ("RTO")

On September 24, 2013, Whiteknight Acquisitions II Inc. ("WKN"), now the Company, acquired 100% of the issued and outstanding shares of Diamond Estates Wines & Spirits Ltd. ("Diamond Ltd."), a private company. The transaction constituted the Qualifying Transaction of WKN as such term is defined in Policy 2.4 of the TSXV. To effect the transaction, WKN issued 26,275,310 common shares and 399,973 share purchase warrants in exchange for the all the issued and outstanding securities of Diamond Ltd. WKN subsequently changed its name to Diamond Estates Wines & Spirits Inc. (“Diamond”), such that Diamond is now the parent company of Diamond Ltd., its 100% owned-subsidiary.

Although the transaction resulted in Diamond Ltd. legally becoming a wholly-owned subsidiary of WKN, the transaction constituted a reverse takeover of WKN and was accounted for as a reverse takeover transaction in accordance with guidance provided in IFRS 2 Share Based Payments. As WKN did not qualify as a business according to the definition in IFRS 3, this reverse takeover transaction did not constitute a business combination. It was treated as an issuance of shares by Diamond Ltd. for the net monetary assets of WKN.

### 5. BUSINESS ACQUISITION AND NON-CONTROLLING INTEREST

On October 1, 2014, the Company and The Kirkwood Group ("TKG") formed a new partnership named Kirkwood Diamond Canada ("KDC" or the "partnership") and began the process of merging their respective agency businesses. The Company has a 50.01% interest in the partnership and a tie-breaking vote on the Executive Committee of the partnership, effectively giving it strategic and directional control over the operations of the partnership. Accordingly, the partnership's financial results have been consolidated into the Company's financial statements starting at the beginning of this reporting period.

Each partner contributed intangible assets, consisting of sales agent and distribution agreements with beverage alcohol suppliers, of their respective agencies to KDC in exchange for their respective partnership interests. For Q3 2015, each partner operated their respective agency businesses independently and carved out the activity for the benefit of the partnership. Each partner therefore also retained ownership of their respective working capital during this period in order to continue to operate their own businesses independently. On a beneficial basis, each partner therefore contributed their respective inventories as at October 1, 2014 to the partnership offset by notes payable. However, accounts receivable and accounts payable balances at October 1, 2014 related to activity prior to the inception of the partnership were retained by the partners such that they did not form part of the business combination. The Company did not issue any equity or cash consideration, contingent or otherwise, to the owners of The Kirkwood Group as a result of this transaction.

The following summarizes the consideration transferred to the partnership by the Company and the partnership assets acquired and liabilities assumed at the acquisition date:

| | |
|---|---|
| **Consideration transferred to KDC by the Company** | |
| Inventories | **$ 1,597,708** |
| Note payable - Diamond | **(1,597,708)** |
| Intangible assets (client lists, customers) | **3,700,000** |
| | **3,700,000** |
| **Fair value of total KDC assets acquired and liabilities assumed** | |
| Inventories | **5,161,228** |
| Notes payable - partner companies (Note 14) | **(5,161,228)** |
| Intangible assets (client lists, customers) | **7,200,000** |
| Net assets acquired before non-controlling interest | **7,200,000** |
| Net assets attributable to Company's contribution eliminated on consolidation | **3,700,000** |
| **Net assets acquired via non-controlling interest** | **$ 3,500,000** |

The fair values of all acquired assets (including intangible) and assumed liabilities have been determined on a provisional basis and are subject to adjustment. These adjustments may include, but are not limited to, post-acquisition review of the fair value of the acquired net assets, deferred tax balance adjustments on the filing of tax returns and final working capital adjustments on the respective balances acquired.

## 5. BUSINESS ACQUISITION AND NON-CONTROLLING INTEREST, CONTINUED

The non-controlling interest in the partnership is 49.99%. It has been measured at fair value, primarily based on the proportionate relative value of each partner's intangible assets as described above. The primary input for that that valuation was the use of each partner's fiscal 2014 gross margin, normalized for variable selling costs and client relationships retained. None of the intangible assets recognized are expected to be deductible for income tax purposes. No value has been attributed to the Company's own intangible assets transferred to the partnership as there can be no gain on disposition within the consolidated entity.

Summarized financial data for KDC as at December 31, 2014, before consolidation eliminations, are as follows:

| | $ |
|---|---|
| Accounts receivable | 2,827,000 |
| Inventories | 4,508,000 |
| Intangible assets | 7,200,000 |
| Accounts payables | (4,264,000) |
| Notes payable - partner companies | (3,370,000) |
| | |
| Revenues | 4,665,000 |
| Net loss | (475,000) |

The Company has recognized $2.8 million of revenue and $125,000 of net loss in the three month period ended December 31, 2014 that would not have otherwise have been recorded in absence of this acquisition. Included in this amount are acquisition-related expenses of $100,000. The Company cannot reasonably determine the total revenue and net income amount that the partnership would have generated had the merger taken effect on April 1, 2014 as not all of the activities of The Kirkwood Group during that period related to the business that became part of the new partnership on October 1, 2014.

Restructuring costs of $488,528 were provided for in the three and nine month periods ended December 31, 2014 to cover employee severance and lease termination costs.

On January 23, 2015, the partnership entered into its own credit facility agreement with Meridian Credit Union, the Company's primary lender, as more fully described in note 21(II)(b).

## 6. DE SOUSA WINE CELLARS CORPORATION SALE AND LEASEBACK

On November 10, 2014, the Company completed the sale and leaseback of its De Sousa Estates Winery in Beamsville, Ontario to Oakwest Corporation Limited ("Oakwest"), the related party described in note 12. This was done through the sale of the common shares in De Sousa Wine Cellars Corporation, the entity that owns the winery property. The details of the sale and leaseback, both done at fair value, are as follows:

(a) The share sale was for cash proceeds of $1,800,000 and resulted in the effective disposition of the winery property, previously classified under assets held for sale *(see note 9)*, resulting in a loss on disposition of $80,916.

## 6. De Sousa Wine Cellars Corporation Sale And Leaseback, continued

(b) Approximately $780,000 of the proceeds were used to retire the remaining outstanding mortgage on the property *(see note 10(b)(ii))*, with the balance of the proceeds used for working capital requirements.

(c) The Company will lease the winery from Oakwest for a period of five years with the option to extend for another five years. Management has determined that the lease is an operating lease as it is a lease for premises with a limited duration. Minimum lease payments due over the first five year term total $500,000. Operating lease payments expensed during the three month period ended December 31, 2014 total $9,780.

(d) The Company will continue to operate the winery under a profit-sharing arrangement with Oakwest under which profits greater than $25,000 in any given year are to be split two thirds in favour of the Company and one third for Oakwest. To date, profits under the profit-sharing arrangement are below the threshold level.

The Company has maintained ownership and all rights to these brands, and funds all working capital requirements.

(e) If Oakwest sells the property during the initial lease term, it will transfer to the Company's benefit all net proceeds in excess of $1,800,000.

## 7. Accounts Receivable

| | **December 31 2014** | March 31 2014 |
|---|---|---|
| Trade receivables | **$ 4,101,259** | $ 2,892,643 |
| Accrued receivables | **80,000** | 135,000 |
| Other | **44,183** | 7,621 |
| | **$ 4,225,443** | $ 3,035,264 |

## 8. Inventories

| | **December 31 2014** | March 31 2014 |
|---|---|---|
| Bulk wine | **$ 8,753,024** | $ 7,463,739 |
| Bottled wine and spirits | **7,794,374** | 4,530,831 |
| Bottling supplies and packaging | **436,346** | 471,592 |
| | **$ 16,983,744** | $ 12,466,162 |

## 9. ASSETS HELD FOR SALE

On November 10, 2014, the assets held for sale were sold for $1,800,000 under the sale and leaseback transaction as described in note 6. Non-current assets are classified as assets held for sale when their carrying amount is to be recovered principally through a sale transaction and a sale is considered highly probable. At the date of sale, the Company had assets held for sale with a carrying amount of $1,880,916 relating to its De Sousa Beamsville winery property (owned by De Sousa Wine Cellars Corp.) located at 3753 Quarry Road, Beamsville, Ontario.

The assets held for sale consisted of all of the land, buildings, equipment and biological assets, net of accumulated depreciation and an impairment provision, as detailed below:

| | **December 31 2014** | March 31 2014 |
|---|---|---|
| Land | **$ -** | $ 496,494 |
| Buildings | **-** | 966,307 |
| Equipment | **-** | 531,045 |
| Biological assets | **-** | 147,070 |
| Impairment provision | **-** | (260,000) |
| | **$ -** | $ 1,880,916 |

(a) These assets had been measured at the lower of their carrying amount and fair value less costs to sell. Based on a current valuation of the property, management recorded an impairment provision of $260,000 as at March 31, 2014.

(b) The property and buildings included in the assets held for sale acted as security for the De Sousa Loan *(see note 10)*. This loan amount was repaid in full out of the sale proceeds.

## 10. BANK INDEBTEDNESS

As at December 31, 2014, the Company was operating under the terms of a credit agreement dated September 17, 2014 with Meridian Credit Union ("MCU"), its primary lender, the details of which are described below.

On January 12, 2015, the Company signed a new credit agreement, the details of which are more fully described in note 21(I)(a), with MCU to replace this agreement.

| | **December 31 2014** | March 31 2014 |
|---|---|---|
| **Meridian Credit Union**: | | |
| Operating Line: revolving operating line of credit, due on demand, interest payments only required monthly, calculated at prime plus 2.50% (currently 5.50%); total credit facility available is $13,000,000, subject to certain margin limits in respect of accounts receivable and inventory | **$ 12,274,083** | $ 12,175,284 |
| De Sousa Loan: loan bearing interest at prime plus 2.50% (currently 5.50%), interest plus principal of $8,215 payable monthly until August, 2023; due by August 31, 2014 *(see also note 9)* | **-** | 837,845 |
| | **12,274,083** | 13,013,129 |
| De Sousa Loan presented separately as associated with assets held for sale (Note 9) | **-** | (837,845) |
| | **$ 12,274,083** | $ 12,175,284 |

On September 17, 2014, the Company signed a new credit agreement with Meridian Credit Union ("MCU"), its primary lender, to replace the previous agreement dated July 24, 2013. The new credit agreement continues to provide a revolving line of credit of up to $13,000,000, but is now subject to an increased margin limit on inventory of $11,000,000, up from $10,000,000. The interest rate on the De Sousa Loan (for the Beamsville winery) has been reduced 50 basis points to prime plus 2.50%. Enhancements to the covenants include:

(i) the inclusion pre-1993 branding licenses (an intangible asset) at 50% in the calculation of net effective worth
(ii) the debt to effective net worth ratio falling to 3.25:1 on March 31, 2016
(iii) maintaining at least three product listings with the Liquor Control Board of Ontario

## 10. BANK INDEBTEDNESS, CONTINUED

The credit agreement now specifies the following overall terms:

(b) ***Credit facilities***

(i) Operating line of $13,000,000, due on demand, bearing interest at prime plus 2.50%, interest payable monthly.
(ii) De Sousa loan of $804,985, due on demand, repayable in monthly principal payments of $8,215 plus interest at prime plus 2.50% *(see also notes 9(c) and (b))*.
(iii) Real estate and equipment term loan of $9,577,101 *(see note 13)*, repayable in blended monthly payments of principal and interest of $94,319, bears interest at a fixed rate of 5.4%, due by December, 2016.

(c) ***Security***

The above credit facilities are secured by general security agreements, collateral mortgages over both the Beamsville property and buildings *(see note 9(c))* and the Niagara Cellars property and buildings, assignment of fire and liability insurance over both properties and buildings, and corporate guarantees and postponements of claim in favour of Meridian by both De Sousa Wine Cellars Corporation and De Sousa Wines Toronto Inc., each of which is supported by respective general security agreements.

(d) ***Financial covenants***

The credit facilities are subject to the following financial covenants:

(i) Achieve a minimum effective net worth of not less than $7,000,000, which is defined as: shareholders' equity plus loans from shareholders postponed to Meridian less loans to shareholders and related parties and less 50% of intangible assets;
(ii) To maintain a debt to effective net worth of 3.75|1.00 measured monthly, improving to 3.25|1.00 by March 31, 2016 (where debt is defined as all funded short and long-term debt, less any postponed amounts); and
(iii) Maintain a debt servicing coverage ("DSC") ratio of not less than 1.25|1.00, calculated on a rolling four quarter basis with the fourth quarter ending March 31, 2015.

From the signing of the initial credit agreement on July 24, 2013 through to December 31, 2014, the Company has been in compliance with the covenants relating to minimum effective net worth and debt to effective net worth. The DSC ratio covenant was not measured for fiscal 2014 by virtue of an amendment to the credit agreement dated March 25, 2014.

### 11. ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

| | **December 31 2014** | March 31 2014 |
|---|---|---|
| Trade payables | **$ 4,420,679** | $ 3,023,310 |
| Accrued liabilities | **778,810** | 296,625 |
| | **$ 5,199,489** | $ 3,319,935 |

### 12. SHAREHOLDER LOAN PAYABLE

The loan, payable to the Company's largest shareholder, is unsecured and bears interest at 8% per annum. It is due by March 31, 2015, but may be renewed by agreement between the parties. Under the provisions of the MCU credit agreement, the amount of this loan has been included in the determination of effective net worth *(see note 10(c)(i))*.

### 13. TERM LOAN PAYABLE

As part of the revised Meridian Credit Union agreement dated September 17, 2014 described in note 10, the due date of the Company's real estate and equipment financing loan was extended to January, 2019 from December, 2016. All other terms and conditions, including interest rate and monthly payment, remained unchanged. As at December 31, 2014, the amount outstanding was as follows:

| | **December 31 2014** | March 31 2014 |
|---|---|---|
| Meridian Credit Union term loan | **$ 9,422,538** | $ 9,828,516 |
| Less: current portion | **(692,894)** | (616,115) |
| | **$ 8,729,644** | $ 9,212,401 |

The major terms of the real estate and equipment term loan are now as follows:

(a) Term of 4 years, 4 months, due by January 2019
(b) Amortized over a period of 143 months
(c) Bears interest at fixed rate of 5.40%:
(d) Repayable in blended monthly payments of principal and interest of $94,319
(e) Secured under the terms of the credit facility as described in note 10, including general security agreements by each Company in the group and a collateral mortgage for $15,000,000 on the property and buildings at the Company's primary place of operations

Estimated principal repayments are as follows:

| | |
|---|---|
| 12 months ending September 30, 2015 | **$ 692,894** |
| 12 months ending September 30, 2016 | **675,815** |
| 12 months ending September 30, 2017 | **714,569** |
| 12 months ending September 30, 2018 | **625,778** |
| 4 months ending January 31, 2019 | **6,713,482** |
| | **$ 9,422,538** |

## 14. NOTE PAYABLE - NON-CONTROLLING INTEREST

As more fully described in note 5, the Company and its partner, TKG, each beneficially transferred the inventories of their respective agency businesses to KDC in exchange for respective notes payable upon commencement of the partnership on October 1, 2014. During the quarter, each partner independently operated their respective sales agency for the benefit of the partnership pending the final valuation and transfer of inventory and other assets being vended into KDC (subject to final tax elections, financing arrangements, etc.). Accordingly, the Company has recorded a note payable to TKG as at December 31, 2014 for KDC working capital balances included on the interim condensed statement of financial position.

| | |
|---|---|
| Accounts receivable | **$ 1,515,203** |
| Inventories | **3,033,264** |
| Accounts payable (trade) | **(1,615,039)** |
| Other | **124,486** |
| | **$ 3,057,914** |

Equivalent working capital balances owing by KDC to the Company have been eliminated on consolidation.

On January 23, 2015, the partnership entered into its own credit facility agreement with Meridian Credit Union, the Company's primary lender, as more fully described in note 21(II)(b).

## 15. LOSS PER SHARE

Basic and diluted loss per share is computed using the weighted average number of common shares outstanding. The weighted average number of common shares outstanding for the three and nine month periods ended December 31, 2014 was 73,403,749 and 73,403,749 respectively (three and nine month period ended December 31, 2013 - 73,360,228 and 35,933,273 respectively). Diluted loss per share and the weighted average number of common shares exclude all potentially dilutive equity instruments since their effect is anti-dilutive.

As at December 31, 2014, the following potentially dilutive equity instruments were all outstanding: (1) 6,682,400 options (December 31, 2013 - 900,000) and (2) 399,973 warrants (December 31, 2013 - 399,973).

## 16. STOCK OPTIONS

The Company has adopted a stock option plan under which it may grant options to acquire shares of the Company to directors, officers and consultants of the Company. The maximum number of common shares issuable pursuant to the plan is equal to 10% of the issued and outstanding common shares at the close of business on the date of any grant, with an additional restriction of 5% to any one individual in a twelve month period.

## 16. STOCK OPTIONS, CONTINUED

Stock option activity for the period from April 1, 2013 to December 31, 2014 is as follows:

| | **Nine month period ended December 31, 2014** | | Year ended March 31, 2014 | |
|---|---|---|---|---|
| | **Options** | **Weighted-average exercise price ($)** | Options | Weighted-average exercise price ($) |
| Outstanding, beginning of period | **3,132,400** | **0.21** | 900,000 | 0.70 |
| Options cancellation and grant | **-** | **-** | (900,000) | 0.70 |
| Granted to CEO | **-** | **-** | 2,000,000 | 0.20 |
| Assumed upon WKN closing | **-** | **-** | 532,400 | 0.20 |
| Granted to BOD | **-** | **-** | 600,000 | 0.25 |
| Granted to CFO *(see note 16(a))* | **500,000** | **0.25** | - | - |
| Granted to Oakwest *(see note 16(b))* | **1,400,000** | **0.12** | - | - |
| Granted to Chairman *(see note 16(b))* | **600,000** | **0.12** | - | - |
| Granted to key management *(see note 16(c))* | **1,050,000** | **0.11** | - | - |
| Outstanding, end of period | **6,682,400** | **0.17** | 3,132,400 | 0.21 |

As at December 31, 2014, the issued and outstanding options to acquire common shares of the Company are as follows:

| | **Number of options** | | | | |
|---|---|---|---|---|---|
| **Grant date** | **Granted** | **Exercisable** | **Exercise price ($)** | **Remaining life** | **Expiry date** |
| September 24, 2013 | 2,000,000 | 1,333,334 | 0.20 | 3.73 | September 23, 2018 |
| September 24, 2013 | 532,400 | 532,400 | 0.20 | 2.17 | March 7, 2017 |
| September 24, 2013 | 600,000 | 399,996 | 0.25 | 3.73 | September 23, 2018 |
| June 5, 2014 | 500,000 | - | 0.25 | 4.67 | June 5, 2019 |
| November 10, 2014 | 1,400,000 | 280,000 | 0.12 | 4.86 | November 9, 2019 |
| November 10, 2014 | 600,000 | 120,000 | 0.12 | 4.86 | November 9, 2019 |
| November 24, 2014 | 1,050,000 | - | 0.11 | 4.89 | November 23, 2019 |
| | 6,682,400 | 2,665,730 | | | |

## 16. STOCK OPTIONS, CONTINUED

The details of the changes in the options during the reporting period are as follows:

(a) **June 5, 2014 grant to CFO:**

(i) On June 5, 2014, a grant of 500,000 options was made to the Company's new CFO. The options are exercisable at $0.25 per share with a term of five years (expiring June 4, 2019) and vest as at 25% of the total number of options granted on each anniversary date over 4 years.

(ii) The fair value of these options has been calculated with the Black-Scholes option pricing model. Using the assumptions of: (1) risk free interest rate of 1.00%, (2) expected volatility of 57%, (3) expected life of 5 years, and (4) dividend yield of 0.0%, the fair value attributed to each option was $0.07.

(b) **November 10, 2014 grant to Oakwest and David Beutel**

(i) Concurrent with the sale and leaseback of the winery *(see note 6)*, the Company has executed an agreement with Oakwest on November 10, 2014 which will provide financial and operational consulting services over the lease term. In consideration of these services, the Company will pay $1 per year and has issued 1,400,000 stock options to Oakwest exercisable at $0.12 per option with a term of five years. The options vested as to 20% immediately and the remainder evenly on each anniversary date over the next 4 years. The Company has also issued 600,000 stock options under the same terms to David Beutel, Chair of its Board of Directors and a Vice President at Oakwest.

(ii) The fair value of these options has been calculated with the Black-Scholes option pricing model. Using the assumptions of: (1) risk free interest rate of 1.00%, (2) expected volatility of 74%, (3) expected life of 5 years, and (4) dividend yield of 0.0%, the fair value attributed to each option was $0.06.

(c) **November 24, 2014 grant to key management personnel:**

(i) The Board of Directors approved the grant of 1,050,000 options to key management personnel. The options are exercisable at $0.11 per option with a term of five years (expiring November 23, 2019) and vest evenly on each anniversary date over 5 years.

(ii) The fair value of these options has been calculated with the Black-Scholes option pricing model. Using the assumptions of: (1) risk free interest rate of 1.00%, (2) expected volatility of 74%, (3) expected life of 5 years, and (4) dividend yield of 0.0%, the fair value attributed to each option was $0.06.

(d) **Share based payments:**

Share based payments were recognized for the three and nine month periods ended December 31, 2014 of $49,613 and $136,280 (three and nine month periods ended December 31, 2013 - $Nil and $190,666) based on accrual of previously granted options expected to vest in the reporting period.

## 17. RELATED PARTY TRANSACTIONS AND BALANCES

During the nine month periods ended December 31, 2014 and 2013, the Company had the following related party transactions, including compensation of key management personnel and directors:

| | 2014 | 2013 |
|---|---|---|
| Salary | $ 459,150 | $ 460,350 |
| Director fees | 135,000 | 51,000 |
| Share based payments under stock option plan *(see note 16(e))* | 136,280 | 190,666 |
| Severance payment | - | 58,500 |
| Interest on shareholder loan *(see note 12)* | 30,000 | - |
| Winery lease payments *(see note 9)* | 9,780 | - |
| Vineyard maintenance | 33,684 | 80,875 |
| Grape purchases | 71,207 | 133,733 |
| Proceeds on sale of Beamsville winery *(see note 9)* | 1,800,000 | - |

Accounts payable and accrued liabilities as at December 31, 2014 includes $97,687 (March 31, 2014 - $117,858) with respect to balances owing to key management personnel and directors.

## 18. SEGMENTED INFORMATION

### Business segments

The Company operates in three business segments, namely the sales of manufactured wines, sales of third-party wines and spirits and commission and other income. The following table represents revenues and direct costs associated with each of these segments for the nine month periods ended December 31, 2014 and 2013:

| | 2014 | 2013 |
|---|---|---|
| ***Revenues*** | | |
| Manufactured wines | $ 11,420,776 | $ 11,408,940 |
| Third-party wines and spirits | 4,956,804 | 2,969,306 |
| Commission and other | 2,529,608 | 2,259,320 |
| | $ 18,907,188 | $ 16,637,566 |
| ***Changes in inventories of finished goods and raw materials consumed*** | | |
| Manufactured wines | $ 6,285,296 | $ 6,941,071 |
| Third-party wines and spirits | 3,245,573 | 1,918,128 |
| | $ 9,530,869 | $ 8,859,199 |

The Company uses the above as the measures of profit within the segments and reviews the assets and liabilities, as well as the amortization of intangible assets, depreciation of property, plant and equipment and interest and financing costs on an entity-wide basis.

## 18. SEGMENTED INFORMATION, CONTINUED

**Geographic information**

| | **2014** | 2013 |
|---|---|---|
| ***Revenues*** | | |
| Canada | **$ 16,607,944** | $ 14,126,665 |
| China and other | **2,299,244** | 2,510,901 |
| | **$ 18,907,188** | $ 16,637,566 |

All of the Company's assets are located in Canada.

## 19. CONTINGENCY

The Company is involved in potential litigation matters arising out of the ordinary course and conduct of its business.

On June 24, 2014, the Company was served with a statement of claim by a former management employee for wrongful termination. Management has reviewed the claim with counsel and believes that it has no merit. No provision for loss has been recorded as a result.

## 20. COMPARATIVE FIGURES

The consolidated financial statements have been reclassified, where applicable, to conform to the presentation adopted in the current period. The changes do not affect prior year earnings.

## 21. SUBSEQUENT EVENTS

The Company entered into two new credit agreements with Meridian Credit Union ("MCU"), its primary lender, in January, 2015, as follows:

**(I) Revised credit agreement for Company dated January 12, 2015 *(see also note 10)***

(a) The operating line decreased from $13,000,000 to $10,000,000, interest rate unchanged (prime plus 2.5%). The margin limit for inventory fell from $11,000,000 to $8,500,000 at 70% of the value of inventory from 90% previously.
(b) $1,500,000 of the prior line of credit was converted to an instalment based non-revolving loan, amortized over 10 years, repayable in equal blended payments of principal and interest of $16,338, bearing interest at fixed rate of 4.99%, due January 15, 2019. Should the Company issue new shareholder equity exceeding $3,000,000, MCU is entitled to an immediate lump-sum payment of $500,000.
(c) A non-revolving loan of $1,250,000, $750,000 of which is to be used for investment in Kirkwood Diamond Canada Partnership *(see note 5)* and $500,000 of the prior line of credit converted to a instalment based non-revolving loan, amortized over 30 months, repayable in equal blended payments of principal and interest of $48,435, bearing interest at a fixed 12%, due by July 15, 2015 .Should the Company issue new shareholder equity exceeding $3,000,000, MCU is entitled to immediate repayment of 100% of the remaining loan balance.
(d) The security positions granted, margining calculations, reporting requirements and financial covenants are generally unchanged, except that the minimum effective net worth required increased from $7,000,000 to $7,500,000.

**(II) Credit agreement for Kirkwood Diamond Canada dated January 23, 2015**

(a) operating line of up to $3,000,000.
(b) payments of interest only, interest at prime plus 2%.
(c) credit facility secured by:
 (i) general security agreement
 (ii) assignment of fire insurance
 (iii) guarantee and postponement of claim from The Kirkwood Group Ltd. in the amount of $1,500,000
 (iv) inter-creditor amongst concerned parties agreement limiting liability of the Company to $1,500,000
(d) Margining calculations and reporting requirements similar to the Company's own credit facility
(e) Financial covenants include:
 (i) maintaining an effective net worth of $1,500,000
 (ii) interest coverage ratio of 1.25|1.00