**IOU Financial Inc.**
**Condensed Consolidated Financial Statements**
**For the Three Months Ended March 31, 2013 and 2012**

**NOTICE OF NO AUDITOR REVIEW OF CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS**

**The accompanying interim condensed consolidated financial statements of IOU Financial Inc for the three months ended March 31, 2013 and 2012 have not been reviewed or audited by the Company's auditors.**

# IOU FINANCIAL INC.

## Interim Consolidated Financial Statements
For the Three Months Ended March 31, 2013 and 2012

PAGE

# IOU Financial Inc.

Interim Consolidated Statements of Financial Position
as at March 31, 2013, December 31, 2012

| | **March 31, 2013 $** | December 31, 2012 $ |
|---|---|---|
| **Assets** | | |
| **Current assets** | | |
| Cash | **863,498** | 1,919,626 |
| Cash held in trust (Note 4) | **720,106** | 286,115 |
| Sales taxes receivable | **91,835** | 48,370 |
| Subscriptions receivable | **-** | 665,000 |
| Commercial loans receivable -net (Note 5) | **9,195,901** | 5,483,574 |
| Other assets (Note 5, Note 16(a)) | **90,414** | 34,371 |
| Prepaid and deposits | **49,063** | 58,113 |
| **Total current assets** | **11,010,817** | 8,495,169 |
| **Equipment** (Note 6) | **31,408** | 25,020 |
| **Intangible asset** (Note 7) | **138,741** | 133,185 |
| **Total assets** | **11,180,966** | 8,653,374 |
| **Liabilities and Shareholders' Equity** | | |
| **Current liabilities** | | |
| Accounts payable and accrued liabilities (Note 8) | **773,568** | 703,009 |
| Funds held in trust for third party lender (Note 5) | **380,751** | 125,577 |
| Financing credit facility (Note 9) | **2,372,790** | 2,576,673 |
| **Total current and total liabilities** | **3,527,109** | 3,405,259 |
| | | |
| **Shareholders' Equity** | | |
| Share capital (Note 10) | **13,705,567** | 11,594,097 |
| Contributed surplus | **2,620,031** | 1,983,784 |
| Foreign currency translation reserve | **(13,276)** | (87,108) |
| Deficit | **(8,658,465)** | (8,242,658) |
| Total Shareholders' Equity | **7,653,857** | 5,248,115 |
| **Total liabilities and Shareholders' Equity** | **11,180,966** | 8,653,374 |

Contingency (Note 17)
Events after the reporting date (Note 18)

The accompanying notes are an integral part of these consolidated financial statements
Approved by the Board:
Phil Marleau (*signed*), Director
Mayco Quiroz (*signed*), Officer

# IOU Financial INC.

Interim Consolidated Statements of Comprehensive Loss
for the Three Months Ended March 31, 2013 and 2012

| | For the three months ended March 31, 2013 | For the three months ended March 31, 2012 |
|---|---|---|
| | $ | $ |
| **Financial Revenue** | | |
| Financing revenue (Note 12) | **695,353** | 184,847 |
| Other fees and servicing income (Note 12) | **106,378** | 864 |
| **Total Financial Revenue** | **801,731** | 185,711 |
| **Financial expenses** | | |
| Interest expense | **(82,730)** | - |
| Provision for loan losses – net of recoveries (Note 5) | **(73,918)** | - |
| Commissions expensed | **(315,282)** | (41,953) |
| **Total Financial expenses** | **(471,930)** | (41,953) |
| **Net financial income before operating and other expenses** | **329,801** | 143,758 |
| Operating expenses (Note 13) | **(745,608)** | (518,144) |
| **Operating loss** | **(415,807)** | (374,386) |
| **Loss before tax** | **(415,807)** | (374,386) |
| Income taxes | **-** | - |
| **Total net loss for the period** | **(415,807)** | (374,386) |
| **Other comprehensive loss:** | | |
| **Items that may be reclassified subsequently to net loss:** | | |
| Currency translation differences | **73,832** | (50,114) |
| **Total comprehensive loss for the period** | **(341,975)** | (424,500) |
| **Net loss and comprehensive loss attributable to:** | | |
| Common shareholders | **(341,975)** | (424,500) |
| **Total comprehensive loss for the period** | **(341,975)** | (424,500) |
| **Loss per share:** | | |
| Basic and diluted loss per share | **(0.01)** | (0.02) |

# IOU Financial INC.

Interim Consolidated Statements of Changes in Shareholders' Equity
for the Three Months Ended March 31, 2013 and 2012

| | Commons Shares (#) | Capital Stock ($) | Contributed Surplus ($) | Deficit ($) | Foreign currency translation reserve ($) | Total Equity($) |
|---|---|---|---|---|---|---|
| Balance as at January 1, 2012 | 26,904,936 | 7,944,983 | 1,087,600 | (6,445,202) | (8,328) | 2,579,053 |
| Conversion of convertible debt | 1,027,267 | 343,659 | - | - | - | 343,659 |
| Stock based compensation | - | - | 4,002 | - | - | 4,002 |
| Warrants issued | - | (5,883) | 5,883 | - | - | - |
| Equity component of convertible debt | - | - | 9,963 | - | - | 9,963 |
| Net loss and comprehensive loss | - | - | - | (374,386) | (50,114) | (424,500) |
| Balance as at March 31, 2012 | 27,932,203 | 8,282,759 | 1,107,448 | (6,819,588) | (58,442) | 2,512,177 |

| | Commons Shares (#) | Capital Stock ($) | Contributed Surplus ($) | Deficit ($) | Foreign currency translation reserve ($) | Total shareholders' equity($) |
|---|---|---|---|---|---|---|
| Balance as at December 31, 2012 | 38,809,453 | 11,594,097 | 1,983,784 | (8,242,658) | (87,108) | 5,248,115 |
| Private Placement -Third tranche (Note 10 (i)) | 3,957,250 | 1,112,297 | 347,891 | - | - | 1,460,188 |
| Private Placement - Fourth Tranche (Note 10 (ii)) | 2,447,000 | 697,016 | 192,586 | - | - | 889,602 |
| Private Placement - Fifth tranche (Note 10 (iii)) | 987,500 | 302,157 | 65,773 | - | - | 367,930 |
| Net loss and comprehensive loss | - | - | - | (415,807) | 73,832 | (341,975) |
| Stock based compensation | - | - | 29,997 | - | - | 29,997 |
| Balance as at March 31, 2013 | 46,201,203 | 13,705,567 | 2,620,031 | (8,658,465) | (13,276) | 7,653,857 |

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

# IOU Financial INC.

Interim Consolidated Statements of Cash Flows
for the Three Months Ended March 31, 2013 and 2012

| | 2013<br>$ | 2012<br>$ |
|---|---|---|
| **Operating Activities** | | |
| Net loss for the period | **(415,807)** | (374,386) |
| Currency translation differences | **73,832** | (50,114) |
| Depreciation of equipment | **2,326** | 1,529 |
| Amortization of intangible asset | **21,677** | 19,121 |
| Amortization of servicing asset | **9,784** | - |
| Servicing asset gain | **(65,098)** | - |
| Interest accretion on convertible promissory note | **-** | 1,327 |
| Stock-based compensation | **29,997** | 4,002 |
| Unrealized foreign exchange loss | **-** | 6,809 |
| Amortization of transactions costs- financing credit facility | **38,865** | - |
| | **(304,424)** | (391,712) |
| Net change in non-cash working capital items (Note 14) | **(6,283,574)** | (732,650) |
| Cash used in operating activities | **(6,587,998)** | (1,124,362) |
| **Financing Activities** | | |
| Funds held in trust for related party lender | **-** | 16,305 |
| Funds held in trust for third party | **255,174** | - |
| Issuance of convertible demand promissory note | **-** | - |
| Issuance of loan payable | **-** | 290,970 |
| Issuance of equity, net of transaction costs | **3,382,721** | - |
| Transaction costs associated with financing credit facility | **(109,754)** | - |
| Repayment of financing credit facility | **(132,994)** | - |
| Cash generated from financing activities | **3,395,147** | 307,275 |
| **Investing Activities** | | |
| Sale of commercial loans | **2,606,661** | 95,879 |
| Additions to intangible asset | **(27,233)** | (30,706) |
| Additions to equipment | **(8,714)** | - |
| Cash held in trust | **(433,991)** | (14,362) |
| Cash acquired on reverse acquisition | **-** | - |
| Cash generated from investing activities | **2,136,723** | 50,811 |
| **Decrease in cash** | **(1,056,128)** | (766,276) |
| **Cash beginning of year** | **1,919,626** | 1,107,465 |
| **Cash end of the period** | **863,498** | 341,189 |

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

## 1. General information

IOU Financial Inc. ("IOUF", "IOU Financial", the "Company") (formerly MCO Capital Inc.) ("MCO") is incorporated under Part 1A of the Business Corporations Act (Quebec) . The registered office of IOU Financial Inc. is located at 1 Place Ville-Marie, Suite 1812, Montreal, Quebec, Canada. Until February 28, 2011, the business of IOU Financial Inc. was to identify and evaluate business assets with a view to a potential acquisition.

On February 28, 2011, IOU Central Inc. ("IOUC", "IOU Central") entered into a share exchange agreement with IOU Financial Inc. for the acquisition by IOUF of all the issued and outstanding shares of IOUC.

IOUC was incorporated under the laws of the Canadian Business Corporations Act on August 10, 2006 and presently operates an Internet based commercial lending business in the United States of America, through its subsidiary, IOU Central Inc. (USA) ("IOU USA"), located in the state of Georgia in the United States of America (Incorporated in Delaware on August 16, 2006).

IOU Financial Inc. is a public company listed on the Canadian National Stock Exchange (CNSX).

These condensed interim consolidated financial statements were authorized for issuance by the Board of Directors of the Company on May 28, 2013.

## 2. Basis of preparation

The condensed interim consolidated financial statements of IOU Financial Inc have been prepared in accordance with International Accounting Standard 34 "Interim Financial reporting" ("IAS 34") as issued by the International Accounting Standards Board ("IASB") and should be read in conjunction with the annual financial statements for the year ended 31 December 2012, which have been prepared in accordance with IFRS.

These condensed interim consolidated financial statements have been prepared on the historical cost basis. Historical cost is generally based on the fair value of the consideration given in exchange for assets. Other measurement bases used are described in the applicable notes.

## 3. Significant accounting policies

The accounting policies adopted are consistent with those of the previous financial year, except as described below.

**Commercial loans receivable**

Commercial loans receivable are recognized initially at fair value and subsequently measured at amortized cost, less impairment losses, using the effective interest rate method. Commercial loans receivable are classified as current assets as collection is expected in one year or less.

When a loan is considered to be impaired, the original expected timing and amount of future cash flows is revised to reflect new loan circumstances. The revised cash flows are discounted using the original effective interest rate to determine the impaired carrying value of the loan. Interest income is thereafter recognized on this impaired carrying value using the effective interest rate.

In the normal course of business, the Company may sell its interests in loans receivable or discharge the borrower from its loan for certain proceeds. The Company derecognizes loans receivable sold only when it has transferred substantially all the risks and rewards of ownership of the assets, which occurs when the Company no longer considers itself to have any significant exposure to the variability in the present value of the future cash flows from the loans receivable. Outstanding proceeds of sold or discharged loans receivable are reported separately from other loans receivable, and measured at their realizable value, net of expected sales costs.

Where the Company retains the servicing rights of loans sold, the benefits of servicing are assessed against market expectations. When the benefits of servicing are more than adequate, a servicing asset is recognized. Servicing assets are carried at amortized cost. Amortization is calculated on a straight line basis over the term of the servicing agreement which approximates one year. When the benefits of servicing are less than adequate, a servicing liability is recognized.

**Changes in accounting policies**

The company has adopted the following new and revised standards, along with any consequential amendments, effective January 1, 2013. These changes were made in accordance with the applicable transitional provisions.

IFRS 10 - Consolidated Financial Statements ("IFRS 10") was issued by the IASB on May 12, 2011 and builds on existing principles by identifying the concept of control as the determining factor in whether an entity should be included within the consolidated financial statements of the parent company. The standard provides additional guidance to assist in the determination of control where this is difficult to assess. The Company assessed its consolidation conclusions on January 1, 2013 and determined that the adoption of IFRS 10 did not result in any change in the consolidation status of any of its subsidiaries.

IFRS 13 - Fair Value Measurement ("IFRS 13"), provides a single framework for measuring fair value. The measurement of the fair value of an asset or liability is based on assumptions that the market participants would use when pricing the asset or liability under current market conditions, including assumptions about risk. The Company adopted IFRS 13 on January 1, 2013 on a prospective basis. The adoption of IFRS 13 did not require any adjustments to the valuation techniques used by the Company to measure fair value and did not result in any measurement adjustments as at January 1, 2013.

The Company has adopted the amendments to IAS 1 – Presentation of financial statements ("IAS 1") effective January 1, 2013. These amendments required the Company to group other comprehensive income items by those that will be reclassified subsequently to profit or loss and those that will not be reclassified. The Company has reclassified income items of the comparative period. These changes did not result in any adjustments to other comprehensive income or comprehensive income.

IFRS 12 - Disclosure of Interests in Other Entities ("IFRS 12"), issued by the IASB on May 12, 2011, is a new standard on disclosure requirements for all forms of interests in other entities, including joint arrangements, associates, special purpose vehicles, and other off balance sheet vehicles. The adoption of IFRS 10 did not result in any change in the consolidation status of any of its subsidiaries.

IFRS 7 – Financial Instruments: Disclosures were issued by the IASB in December 2011 and addresses inconsistencies in practice when applying offsetting criteria for financial assets and liabilities. The adoption of the amendments to IFRS 7 did not have an impact on the Company's financial information.

**Future changes in accounting policies**

IFRS 9 - Financial Instruments ("IFRS 9") was issued by the IASB on November 12, 2009 and will replace IAS 39 Financial Instruments: Recognition and Measurement ("IAS 39"). IFRS 9 uses a single approach to determine whether a financial asset is measured at amortized cost or fair value, replacing the multiple rules in IAS 39. 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, 2015. The Company is currently evaluating the impact of IFRS 9 on its consolidated financial statements.

Amendments to IAS 32 – Financial Instruments: Presentation was issued by the IASB in December 2011 and address inconsistencies in practice when applying offsetting criteria for financial assets and liabilities. The amendments to IAS 32 are effective for annual periods beginning on or after January 1, 2014. The Company is currently evaluating the impact of this amendment on its consolidated financial statements.

**Presentation**

The presentation of the consolidated statement of comprehensive loss was changed for the 2012 financial year end and therefore the quarterly results, for comparative purposes with 2013, have also been reclassified into new categories from previously issued 2012 quarterly results. Management has determined that the new presentation provides information that is reliable and more relevant to users of the financial statements. The reclassifications were as follows:

| 2012 Classification | Amount previously disclosed | New classification |
|---|---|---|
| Finance Costs | (4,414) | Operating expenses |
| Administrative expenses (1) | (555,683) | Operating expenses |

(1) Previously included in total administrative expenses for 2012 is an amount of $41,953 relating to commissions expensed. These have been reclassified as "financial expenses".

Management has presented a new category of expense in 2012, "financial expenses", which include all expenses directly related to the generation of revenues and therefore include interest paid on the financing credit facility introduced in 2012. All other interest expense has been included in "Operating expenses".

**Use of Estimates and judgements**

The preparation of the interim consolidated financial statements in conformity with IFRS requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the consolidated financial statements and reported amounts of revenues and expenses during the period. Actual results could differ from management's best estimates as additional information becomes available in the future.

In preparing these condensed interim consolidated financial statements, the significant judgements made by management in applying the group's accounting policies and the key sources of estimation uncertainty were the same as those applied to the consolidated financial statements for the year ended December 31, 2012.

## 4. Cash held in trust

Cash held in trust amounted to $720,106 (2012: $286,115). Cash held in trust comprises funds held on behalf of a third party loan purchaser, bonding insurance collateral and cash held as security for lending activities.

## 5. Commercial loans receivable

As at March 31, 2013 and December 31, 2012, the Company held commercial loans receivable as part of its regular operations.

| | **March 31, 2013** | December 31, 2012 |
|---|---|---|
| | **$** | $ |
| Commercial loans receivable-gross | **9,186,250** | 5,581,231 |
| Deferred origination fee revenue | **(445,156)** | (274,863) |
| Transaction costs | **524,408** | 277,135 |
| Less Allowance for loan losses | **(69,601)** | (99,929) |
| Commercial loans receivable -net | **9,195,901** | 5,483,574 |

The loans bear fixed interest at rates ranging between 12.99% - 33.45% (2012: 12.99% - 34.00%) and mature no later than 12 months after each balance sheet date. Guarantee fees charged on each loan range between 0.00% and 12.00% (2012: 0.00% - 11.50%) of the original loan amount. The loans are being repaid daily over their terms. Loans are not collateralized, but are backed by a general security agreement against all of the assets of the business and are personally guaranteed by the owner(s) of the business. The commercial loans receivable are denominated in US dollars. Transaction costs comprise broker commissions and are deferred over the term of the loan in accordance with the Company's accounting policy. An origination fee of 4.95% of the original loan amount is charged on each loan and this revenue is deferred and amortized to income over the term of the loan in accordance with the Company's accounting policy.

Impaired loans and allowances for loan losses:

At period end, the Company performed a comprehensive review of its loan portfolio for the purposes of determining any specific allowances for each loan. The fair value of the loans (net of allowance), at March 31, 2013 and December 31, 2012 was $9,116,649 and $5,481,302 respectively.

Movements in the allowance for loan losses are as follows:

| | March 31, 2013 | December 31, 2012 |
|---|---|---|
| | $ | $ |
| Allowance at January 1 | **99,929** | - |
| Provision for receivables impairment | **75,935** | 273,511 |
| Receivables written off during the year as uncollectible | **(106,263)** | (173,608) |
| Foreign exchange | | 26 |
| Allowance at the end of the period | **69,601** | 99,929 |

Amounts charged to the allowance are written off, when there is no expectation of recovering additional cash. Included in "Financial Expenses" is a recovery of $2,017 (2012- $Nil) for loans previously written off as uncollectible.

Age and Credit Quality:

An analysis of the age of the loans receivable in each period presented is as follows:

| | March 31, 2013 | | December 31, 2012 | |
|---|---|---|---|---|
| **Age** | $ | | $ | |
| Current | **8,569,318** | **93.28%** | 5,113,921 | 91.63% |
| Payments in arrears: | | | | |
| 1 to 21 payments | **403,592** | **4.39%** | 321,754 | 5.76% |
| 22- 63 payments | **196,543** | **2.14%** | 58,384 | 1.05% |
| 64 + payments | **16,797** | **0.19%** | 87,172 | 1.56% |
| Total | **9,186,250** | **100%** | 5,581,231 | 100% |

An analysis of the credit quality of the loans receivable in each period presented is as follows:

| | March 31, 2013 | | December 31, 2012 | |
|---|---|---|---|---|
| **Credit Quality** | $ | | $ | |
| Neither past due nor impaired | **8,569,318** | **93.28%** | 5,113,921 | 91.63% |
| Past due but not impaired: | | | | |
| 1 to 21 payments | **291,029** | **3.17%** | 321,754 | 5.76% |
| 22-63 payments | **137,861** | **1.50%** | 8,689 | 0.16% |
| Impaired | **188,042** | **2.05%** | 136,867 | 2.45% |
| Total | **9,186,250** | **100%** | 5,581,231 | 100% |

Past due but not impaired balances relate to financial assets which are contractually overdue but are not deemed to be impaired. Based on historical information on borrower default rates, management considers the credit quality of loan receivables that are neither past due nor impaired to be satisfactory.

Loan sales:

During the three months ended March 31, 2013, the Company sold some of its commercial loans receivable, on a non-recourse basis, at no gain or loss, for total proceeds of $2,606,661 (USD$ 2,593,042). At the time of the sale, the Company transferred to the purchaser of such loans all rights and risks associated with the loans sold, and the Company determined that the criteria for derecognition contained in IAS 39 Financial Instruments had been met. However, as per the debt assignment agreements, the Company retained the servicing rights (payment collections) to the loans and the purchaser agreed to be charged a servicing fee over the term of the loans. In accordance with the Company's accounting policy, a servicing asset (net of amortization) of $55,314 has been recognized on these loans sales and has been included in "other assets". At March 31, 2013, there was $380,751 (2012: $125,577) held in trust on behalf of this party.

## 6. Equipment

| | Office Equipment | Computer Equipment | Total |
|---|---|---|---|
| **Cost** | | | |
| Balance at January 1, 2012 | 21,146 | 8,753 | 29,899 |
| Additions | 15,380 | 9,257 | 24,637 |
| Balance at December 31, 2012 | 36,526 | 18,010 | 54,536 |
| Additions | 4,743 | 3,971 | 8,714 |
| Balance at March 31, 2013 | 41,269 | 21,981 | 63,250 |
| **Accumulated depreciation** | | | |
| Balance at January 1, 2012 | 18,432 | 3,568 | 22,000 |
| Depreciation charge for the year | 4,318 | 3,198 | 7,516 |
| Balance at December 31, 2012 | 22,750 | 6,766 | 29,516 |
| Depreciation charge for the year | 1,043 | 1,283 | 2,326 |
| Balance at March 31, 2013 | 23,793 | 8,049 | 31,842 |
| **Carrying amounts** | | | |
| At December 31, 2012 | 13,776 | 11,244 | 25,020 |
| At March 31, 2013 | 17,476 | 13,932 | 31,408 |

## 7. Intangible asset

Intangible assets are comprised of internal use software.

| | **March 31, 2013 $** | December 31, 2012 $ |
|---|---|---|
| **Cost** | | |
| Beginning of Year | **1,165,493** | 1,056,110 |
| Investment tax credits applied | **-** | (28,064) |
| Acquisitions –Internally developed | **27,233** | 137,447 |
| Balance – End of Year | **1,192,726** | 1,165,493 |
| **Accumulated amortization** | | |
| Balance - Beginning of Year | **1,032,308** | 942,554 |
| Amortization charge for the year | **21,677** | 89,754 |
| Balance – End of Year | **1,053,985** | 1,032,308 |
| **Carrying amount** | | |
| December 31, 2012 | **133,185** | 113,556 |
| March 31, 2013 | **138,741** | 133,185 |

## 8. Accounts payable and accrued liabilities

| | **March 31, 2013 $** | December 31, 2012 $ |
|---|---|---|
| Trade Payables | **596,099** | 507,132 |
| Loans in transit | **96,179** | 88,920 |
| Other payables and accruals | **81,290** | 106,957 |
| Total | **773,568** | 703,009 |

## 9. Financing credit facility

At the end of the period, the carrying value of the liability amounted to:

| | **March 31, 2013** | December 31, 2012 |
|---|---|---|
| | **$** | $ |
| Financing credit facility | **2,553,967** | 2,632,114 |
| Less transaction costs (net of amortization) | **(181,177)** | (69,153) |
| Provision for minimum finance costs | **-** | 13,712 |
| Total | **2,372,790** | 2,576,673 |

On April 30, 2012, the Company and its subsidiary entered into a financing credit facility agreement with a third party Lender. In terms of this agreement, the Lender has agreed to provide a one year, secured credit facility to the Company's subsidiary for up to $3 million. Interest on the facility is calculated at the per annum rate of fourteen percent above US base rate. This credit facility is being repaid daily over its term and will automatically renew for one year periods unless either party gives termination notice. In terms of this agreement, all assets held by the company's subsidiary and IOUF are collateralized against the facility, up to a maximum amount of $15 million.

| **Asset** | **Carrying Amount at March 31, 2013** |
|---|---|
| Equipment | $31,408 |
| Commercial loans receivable-net | $9,195,901 |
| Intangible asset | $138,741 |
| Cash | $1202,853 |
| Other assets | $231,312 |

As part of the covenants, the Company shall either cause IOUC to file articles of dissolution and to distribute all of the assets thereof to IOUF or the Company will cause IOUC to be named a party to the Agreement as a solidary co-borrower and to grant additional security agreements acceptable to the Lender. In accordance with IAS 39, "Financial Instruments: Recognition and Measurement", transaction costs directly attributable to the acquisition of the above financial liability have been included in the initial measurement of the liability and are being amortized over the term of the agreement. Amortization of $38,865 has been included in "Operating expenses".

On March 14, 2013, the Company renewed and increased the facility from $3 million to US$10 million for an additional one year term. The lender has an option to extend the contract by an additional year by providing IOU with an increase in the facility to US$15.0 million. Under the renewed agreement with the lender, interest on the facility was reduced by two percent to a per annum rate of twelve percent above US base rate. In any month where the average balance of the facility is equal to or greater than US$6.0 million, the interest on the facility will be further reduced by two percent to a per annum rate of ten percent above US base rate. In any month where the average balance of the facility is equal to or greater than US$10.0 million, the interest on the facility will be further reduced by one percent to a per annum rate of nine percent above US base rate. The terms of the renewal will come into effect on June 15, 2013 or in any month before June 15, 2013 where the average borrowings under the facility are in excess of $3,000,000.

## 10. Capital stock

Authorized

Unlimited number of Class A subordinate shares, entitled to one vote per share, convertible under certain circumstances into Class B shares, without par value.

Unlimited number of Class B shares, entitled to one vote per share, convertible at the option of its holder into Class A subordinate shares at a rate of one Class B share for one Class A subordinate share, without par value.

Unlimited number of Class A preferred shares, 7% cumulative dividend on the redemption price, retractable at paid-up amount, without par value.

Unlimited number of Class B preferred shares, issuable in series and whose attributes can be determined by the Board of directors.

As at March 31, 2013, IOU Financial Inc. had 2,146,355 shares in escrow (December 31, 2012: 2,146,355).

**Issued**

| | **March 31, 2013 $** | December 31, 2012 $ |
|---|---|---|
| 46,201,203 ( 2012: 38,809,453) Class B shares | **13,705,567** | 11,594,097 |

**Warrants**

A continuity schedule of outstanding common share purchase warrants for the periods presented are as follows:

| | |
|---|---|
| Balance at January 1, 2012 | 14,847,427 |
| Issued | 10,032,717 |
| Exercised | - |
| Forfeited | - |
| Expired | (13,128,907) |
| Balance at December 31, 2012 | 11,751,237 |
| Granted | 6,053,053 |
| Expired | (366,038) |
| Balance at March 31, 2013 | 17,438,252 |

i) On February 19, 2013, IOU Financial closed the third tranche of a $5 million private placement of units, each unit consisting of one Class B common share (a "Class B Share") and a 0.75 Class B Share purchase warrant (a " Warrant") (collectively referred to as the "Units"), for gross proceeds of $1,582,900 and which resulted in a total issuance of 3,957,250 Class B Shares as well as 2,967,937 Warrants. Each Warrant entitles its holder to acquire one Class B Share at a price of $0.60 until August 19, 2014. Transaction costs of $23,829 have been offset against share capital.

The fair value of the above mentioned warrants was determined using the Black-Scholes option pricing model with a weighted average volatility of 78%, risk-free interest rate of 1.06%, dividend yield of nil and an expected life of 1.5 years. The fair value of these warrants was determined to be $297,091

The Company paid to exempt market dealers a total of $98,882 in commissions as well as additional consideration in the form of 247,206 warrants to purchase Class B Shares (the "Broker Warrants"). Each Broker Warrant entitles its holder to acquire one Class B Share at a price of $0.40 for a period of three years from the date of its issuance and at a price of $0.50 and $0.60 respectively for the fourth and fifth years from the date of its issuance.

The fair value of the broker warrants was determined using the Black-Scholes option pricing model with a weighted average volatility range of 75% -76%, risk-free interest rate of 1.14%- 1.40%, dividend yield of nil and an expected life of 3-5 years. The fair value of these warrants was determined to be $50,801. This amount has been offset against capital stock.

ii) On March 14, 2013, IOU Financial closed the fourth tranche of a $5 million private placement of units, each unit consisting of one Class B common share (a "Class B

Share") and a 0.75 Class B Share purchase warrant (a "Warrant") (collectively referred to as the "Units"), for gross proceeds of $978,800 and which resulted in a total issuance of 2,447,000 Class B Shares as well as 1,835,250 Warrants. Each Warrant entitles its holder to acquire one Class B Share at a price of $0.60 until September 14, 2014. Transaction costs of $8,484 have been offset against share capital.

The fair value of the abovementioned warrants was determined using the Black-Scholes option pricing model with a weighted average volatility of 78%, risk-free interest rate of 1.04%, dividend yield of nil and an expected life of 1.5 years. The fair value of these warrants was determined to be $155,629

The Company paid to exempt market dealers a total of $80,714 in commissions as well as additional consideration in the form of 201,785 warrants to purchase Class B Shares (the "Broker Warrants"). Each Broker Warrant entitles its holder to acquire one Class B Share at a price of $0.40 for a period of three years from the date of its issuance and at a price of $0.50 and $0.60 respectively for the fourth and fifth years from the date of its issuance

The fair value of the broker warrants was determined using the Black-Scholes option pricing model with a weighted average volatility range of 75% -76%, risk-free interest rate of 1.05%- 1.31%, dividend yield of nil and an expected life of 3-5 years. The fair value of these warrants was determined to be $36,957. This amount has been offset against capital stock.

iii) On March 26, 2013, IOU Financial closed the fifth and final tranche of a $5 million private placement of units, each unit consisting of one Class B common share (a "Class B Share") and a 0.75 Class B Share purchase warrant (a "Warrant") (collectively referred to as the "Units"), for gross proceeds of $395,000 and which resulted in a total issuance of 987,500 Class B Shares as well as 740,625 Warrants. Each Warrant entitles its holder to acquire one Class B Share at a price of $0.60 until September 26, 2014. Transaction costs of $2,970 have been offset against share capital.

The fair value of the abovementioned warrants was determined using the Black-Scholes option pricing model with a weighted average volatility of 78%, risk-free interest rate of 1.03%, dividend yield of nil and an expected life of 1.5 years. The fair value of these warrants was determined to be $55,621

The Company paid to exempt market dealers a total of $24,100 in commissions as well as additional consideration in the form of 60,250 warrants to purchase Class B Shares (the "Broker Warrants"). Each Broker Warrant entitles its holder to acquire one Class B Share at a price of $0.40 for a period of three years from the date of its issuance and at a price of $0.50 and $0.60 respectively for the fourth and fifth years from the date of its issuance

The fair value of the broker warrants was determined using the Black-Scholes option pricing model with a weighted average volatility range of 75% -76%, risk-free interest rate of 1.02%- 1.24%, dividend yield of nil and an expected life of 3-5 years. The fair value of these warrants was determined to be $10,152. This amount has been offset against capital stock.

As at March 31, 2013 outstanding share purchase warrants are:

| Exercise Price | Expiry Date | # | Note |
|---|---|---|---|
| $0.27 USD | 11-Dec-13 | 704,590 | |
| $0.40 | 29-Apr-13 | 229,146 | |
| $0.40 | 20-Jun-13 | 608,746 | |
| $0.40 | 15-Jul-13 | 50,000 | |
| $0.50 | 05-Apr-13 | 900,000 | |
| $0.40 | 05-Apr-14 | 22,500 | |
| $0.50 | 13-Apr-13 | 2,192,500 | |
| $0.40 | 13-Apr-14 | 151,250 | |
| $0.50 | 03-Apr-14 | 12,000 | |
| $0.40 | 30-May-17 | 60,000 | |
| $0.40 | 30-May-14 | 30,000 | |
| $0.60 | 21-Jun-14 | 4,591,687 | |
| $0.40 | 21-Dec-17 | 459,155 | |
| $0.60 | 28-Jun-14 | 1,246,875 | |
| $0.40 | 28-Dec-17 | 126,750 | |
| $0.60 | 19-Aug-14 | 2,967,937 | **(i)** |
| $0.40 | 19-Feb-18 | 247,206 | **(i)** |
| $0.60 | 14-Sept-14 | 1,835,250 | **(ii)** |
| $0.40 | 14-Mar-18 | 201,785 | **(ii)** |
| $0.60 | 26-Sept-14 | 740,625 | **(iii)** |
| $0.40 | 26-Mar-18 | 60,250 | **(iii)** |
| **TOTAL** | | **17,438,252** | |

**Stock-Based Compensation:**

Employee Stock Option Plan:

There have been no significant changes in the employee stock option plan during the 3 month period ending March 31, 2013. Share options awarded during the periods presented are as follows:

| | Options Outstanding | Average exercise price per share option ($) |
|---|---|---|
| Balance at January 1, 2012 | 306,242 | 0.40 |
| Granted | 1,665,000 | 0.41 |
| Exercised | - | - |
| Forfeited | - | - |
| Expired | - | - |
| Balance on December 31, 2012 | 1,971,242 | 0.41 |
| Granted | - | - |
| Forfeited | (120,000) | 0.41 |
| Balance on March 31, 2013 | 1,851,242 | 0.41 |

The following summarizes information about share options outstanding at March 31, 2013:

| Exercise price | Number of options | Number exercisable | Expiry Date |
|---|---|---|---|
| 0.40 | 306,242 | 229,681 | Sept-2013 |
| 0.40 | 1,295,000 | 431,667 | Apr-2017 |
| 0.45 | 250,000 | 250,000 | Jan-2014 |
| | 1,851,242 | 911,348 | |

On April 4, 2012 the Company granted options entitling certain directors, officers, employees and consultants of the Company to acquire up to an aggregate of 1,415,000 Class B common shares of the Company at an exercise price of $0.40 per share. These options vest over a three year period, with one third vesting immediately and one-third which shall vest on each of the first and second anniversaries of the date of the grant. Each option is exercisable for a period of five years from the date of grant, provided that it has vested.

| | Tranche 1 | Tranche 2 | Tranche 3 |
|---|---|---|---|
| Number of options | 471,667 | 471,667 | 471,666 |
| Exercise price | 0.40 | 0.40 | 0.40 |
| Expected volatility | 71% | 70% | 68% |
| Risk free interest rate | 1.25% | 1.25% | 1.25% |
| Expected life (years) | 5 | 4 | 3 |
| Dividend yield | 0% | 0% | 0% |
| Grant-date fair value (per option) | $0.20 | $0.18 | $0.15 |

For the period ended March 31, 2013 the Company recognized a stock based compensation cost relating to the above employee stock option plan of $29,953 (December 31, 2012: $193,412).

## 11. Financial risk management

The Company is exposed to a variety of financial risks including credit risk, liquidity risk, and market risk (including foreign exchange and interest rate). The condensed interim financial statements do not include all financial risk management information and disclosures required in the annual financial statements; they should be read in conjunction with the Company's annual financial statements as at 31 December 2012. There have been no changes in the Company's risk management policies since year end.

a) Credit Risk

The Company's maximum credit risk is the carrying value of the cash, cash held in trust, other receivables and commercial loans receivable. As of March 31, 2013, $188,042 (December 31, 2012 - $136,867) of the commercial loans receivable were impaired and an allowance for expected losses of $69,601 has been established (December 31, 2012: $99,929) (Refer to Note 5).

b) Liquidity Risk

Compared to year end, there was no material change in the contractual undiscounted cash out flows for financial liabilities.

c) Foreign Exchange Risk

The Company operates internationally and is exposed to foreign exchange risk arising from currency exposure with respect to the US dollar. Foreign exchange risk arises from foreign denominated future commercial transactions and recognized assets and liabilities.

The Company's foreign exchange exposure as at March 31, 2013 and December 31, 2012 relates to the US dollar commercial loans receivable, cash, accounts payable and accrued liabilities and Financing credit facility. The exchange rate applied as at March 31, 2013 was 1.016 (2012: 0.9949).

Based on the Company's foreign currency exposure noted above, varying the above foreign exchange rates to reflect a one (1) percent strengthening of the Canadian dollar would have decreased the net loss by approximately $74,073 ( 2012: $25,374), assuming that all other variables remained constant. An assumed one (1) percent weakening of the Canadian dollar would have had an equal but opposite effect on the above currencies to the amounts shown above, on the basis that all other variables remain constant.

d) Interest Rate Risk

The Company is subject to interest rate risk on its cash and cash held in trust. Sensitivity to a 1% change in interest rates would not have a material effect.

None of the Company's current commercial lending is based on variable interest rates. The Company is also exposed to changes in the value of a loan when that loan's interest rate is at a rate other than current market rate. The Company mitigates this risk by lending for short terms, with terms at the inception of the loan generally varying from six months to one year.

The Company is exposed to cash flow interest rate risk on its finance credit facility issued at a variable rate. During 2012 and 2013, the borrowings at a variable rate were denominated in USD. The Company mitigates this risk by borrowing for a 12 month term and therefore the Company does not believe that its exposure to interest rate risk is significant.

Interest income presented in the consolidated statement of comprehensive loss represents interest income on financial assets that are classified as loans and receivables.

## 12. Revenue by category

| | For the three months ended March 31 | |
|---|---|---|
| | $ | $ |
| | **2013** | 2012 |
| **Analysis of revenue by category:** | | |
| - Interest and guarantee fee income | **423,506** | 141,437 |
| - Origination fees | **271,847** | 43,410 |
| Total financing revenue | **695,353** | 184,847 |
| Other fees and servicing income: | | |
| - Non- sufficient funds fees | **1,609** | 415 |
| - Referral fees | **2,538** | - |
| - Servicing fees | **36,899** | 450 |
| - Gain on servicing asset recognized | **65,332** | - |
| Total other fees and servicing income | **106,378** | 864 |
| **Total financial revenue** | **801,731** | 185,711 |

## 13. Operating expenses

| | **For the three months ended March 31, 2013 $** | For the three months ended March 31, 2012 $ |
|---|---|---|
| **Operating expenses:** | | |
| Wages and Salaries | **274,424** | **126,888** |
| Stock based compensation | **29,997** | **4,002** |
| Consulting fees | **10,492** | **671** |
| Sales Taxes | **22,032** | **11,179** |
| Rental Expense | **25,038** | **24,761** |
| Insurance | **15,488** | **16,143** |
| Amortization of transactions costs – credit facility | **38,239** | **-** |
| Interest expense | **5,844** | **4,822** |
| Professional Fees | **50,830** | **137,445** |
| Legal and accounting fees | **95,380** | **112,964** |
| Business Fees and Licenses | **5,975** | **5,713** |
| Travel and Entertainment | **11,272** | **17,207** |
| Telecommunications | **5,756** | **2,009** |
| Data services, IT costs and other | **65,410** | **26,919** |
| Advertising and Promotion | **39,461** | **5,442** |
| Depreciation and amortization | **33,787** | **20,650** |
| Realized foreign exchange loss/(gain) | **16,183** | **-** |
| Interest Accretion | **-** | **1,327** |
| **Total Operating Expenses** | **745,608** | **518,143** |

## 14. Supplemental cash flow information

a) Cash flows from operations include interest paid of $82,730 (2012 - $3,087) and interest received of $227,669 (2012: $121,758)

b) Net change in non-cash working capital items is comprised of the following:

| | **2013 $** | 2012 $ |
|---|---|---|
| Sales taxes receivable | **(43,465)** | 2,037 |
| Other assets | **(729)** | 2,482 |
| Commercial loans receivable | **(6,318,989)** | (823,464) |
| Prepaid and deposits | **9,050** | 5,234 |
| Accounts payable and accrued liabilities | **70,559** | 81,061 |
| | **(6,283,574)** | (732,650) |

## 15. Related party transactions

Except as disclosed elsewhere, the Company had the following transactions with related parties:

a) During 2010 and through a series of debt assignment agreements, the Company sold some of its commercial loans receivable to a related party, at no gain or loss, for total proceeds of $176,988. The related party transaction was measured at the fair value of the commercial loans receivable at the date of assignment. At the time of the sale, the Company transferred to the purchaser of such loans all rights and risks associated with the loans sold, and the Company determined that the criteria for derecognition contained in IAS 39 Financial Instruments had been met. However, as per the debt assignment agreements, the Company retained the servicing rights (payment collections) to the loans. Included in other receivables is an amount of $32,769 ($US 32,253) (2012 –$32,089) due from this related party as a result of an overpayment made by the Company with regard to the above sale transaction. This debt has been repaid in full subsequent to period end.

b) On April 1, 2011, IOU Central Inc (USA), a wholly-owned subsidiary of the Company entered into a consulting agreement with an officer of IOU Central Inc (USA). In terms of this agreement, the officer would provide sales and operational services to the Corporation in addition to his duties as officer. The agreement had a fixed 6 month term and could have been terminated at any time by the Corporation. The fee amounted to USD$7,500 monthly payments over the term of the agreement. An amount of $22,476 (USD$22,500) has been included in Professional service fees for the 2012 period (2013: Nil). This agreement was terminated by the Company in June 2012.

c) In May 2011, the Company began renting its Canadian office space from a company under common control. This lease is renewable every 12 months under similar terms and may be cancelled by IOU Financial Inc. upon a given notice period of 6 months prior to the end of the lease term. The amount expensed as rent for the year relating to this lease amounts to $14,700 excluding applicable taxes (2012: $ 12,600). The terms of this operating lease are similar to those that would have been present for an arm's length transaction.

d) The CEO and director of IOUF is a shareholder in a company that owns a significant stake in Palos Capital Corporation, the parent company of Palos Management Inc ('Palos'), one of IOUF's co-lead brokers in the private placement that commenced in December 2012. Palos received commissions and warrants relating to the $5million private placement amounting to $70,217 (2012: $119,424) and 175,543 (2012: 298,561) respectively.

e) Key Management Compensation

Key management compensation amounted to $85,381 for the three months ended March 31, 2013 (March 31, 2012: $ 56,879)

| | **2013** **$** | 2012 $ |
|---|---|---|
| Salaries and other short-term employee benefits | **(62,307)** | (54,923) |
| Share-based payments | **(23,074)** | (1,956) |
| | **(85,381)** | (56,879) |

## 16. Commitments

i) Operating lease commitments – subsidiary company as lessee

In June 2012, The Company's subsidiary began leasing its US office under a non cancellable operating lease agreement. The term of the lease is 38 months and may be cancelled only after 26 months upon the payment of a termination fee. The lease agreement is renewable at the end of the lease period for a similar term.

The future aggregate minimum lease payments under the non-cancellable operating lease are as follows:

| | 2013<br>$ |
|---|---|
| No later than 1 year | **56,670** |
| Later than 1 year and no later than 2 years | **120,912** |
| | **177,582** |

## 17. Contingency

During the year 2006, a lawsuit in the amount of $770,799 was brought against several parties including MCO, now the Company. Other defendants to the proceedings include an engineer as well as a manufacturer of flooring systems and trusses. The lawsuit pertains to remedial work for cracks that have appeared in the granite floor of the Plaintiffs private residence. In the year 2000, MCO (formerly Matco Ravary, a company that specialized in the retailing of home improvement and building materials) supplied some of the structural components used in the construction of this residence. In management's opinion, the lawsuit is exaggerated and without merit and the outcome of the lawsuit and the amount, if any, which the Company would be required to pay, is not determinable. Consequently, no provision is accounted for in the financial statements. (Refer to Note 18 "Events after the reporting date")

## 18. Events after the reporting date

- During the months of April and May of 2013, the Company sold part of its commercial loans receivable, on a non-recourse basis, at no gain or loss, for total proceeds of $2,569,535 (USD$ 2,532,374). At the time of the sale, the Company transferred to the purchaser of such loans all rights and risks associated with the loans sold and the Company determined that the criteria for derecognition contained in IAS 39 Financial Instruments had been met. However, as per the debt assignment agreements, the Company retained the servicing rights (payment collections) to the loans and the purchaser agreed to be charged a servicing fee over the term of the loans.

- With regard to the contingency noted above in Note 17, the Company signed a letter agreement in April 2013, with one of the defendants ("Defendant"), whereby the Defendant agreed to indemnify the Company for damages that the Company would be ordered to pay the Plaintiffs pursuant to the lawsuit, should those damages be in relation to the structural components and related advice that was furnished to the Plaintiffs by the former Matco Ravary. Although the agreement excludes indemnification for damage payments ordered pursuant to the personal fault or negligence of Matco Ravary's representatives, no evidence of such fault or negligence was submitted at trial, and Plaintiffs made no such allegations. In return, and in order to avoid any unnecessary actions between the Defendant and the Company flowing from the recourse in warranty by the Company against the Defendant, the Company agreed to desist itself from its action in warranty against the Defendant. As a result, and in management's opinion, the maximum amount of liability that the Company may be exposed to under the above lawsuit is that which will be associated with the legal cost that the Company will incur to defend itself. Legal costs incurred by the Company during 2013 as it relates to these proceedings amounted to approximately $45,482.

- On April 29, 2013 the Company granted options entitling certain officers and employees of the Company to acquire up to an aggregate of 1,384,000 Class B common shares of the Company at an exercise price of $0.40 per share. These options vest over a three year period, with one third vesting immediately and one-third vesting on each of the first and second anniversaries of the date of the grant. Each option is exercisable for a period of five years from the date of grant, provided that it has vested.