



**COVINGTON FUND II INC.**

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MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL REPORTING

The accompanying financial statements of Covington Fund II Inc. (the "Fund" / "Fund II") are the responsibility of management. They have been prepared in accordance with International Financial Reporting Standards and include certain amounts that are based on estimates and judgements. The significant accounting policies which management believes are appropriate for the Fund are described in Note 3 to the financial statements.

Management has developed and maintains a system of internal controls to provide reasonable assurance that all assets are safeguarded and to produce relevant, reliable and timely financial information, including the accompanying financial statements.

The Board of Directors discharges its duties to the financial statements primarily through the activities of its Valuation and Audit Committees (the "Committees"), which are composed of members of the Board of Directors. The Valuation Committee has responsibility for approving the Fund's Net Asset Values as calculated by management in accordance with the Fund's valuation policies. The Audit Committee meets with management and the external auditors to review both the financial statements and the results of the audit examination. The external auditors have unrestricted access to the Committees. The Committees also consider, for review by the Board of Directors and approval by the shareholders, the engagement or re-appointment of the external auditors.

These financial statements have been approved by the Board of Directors and have been audited by Ernst & Young LLP, Chartered Professional Accountants and Licensed Public Accountants on behalf of the shareholders. The independent auditors' report outlines the scope of their audit and their opinion on the financial statements.



Scott D. Clark  
President & CEO,  
Covington Capital Corporation



Stephen Campbell  
Chief Financial Officer,  
Covington Capital Corporation

Toronto, Canada  
November 10, 2017

INDEPENDENT AUDITORS' REPORT

**To the Class A Shareholders of Covington Fund II Inc. (the "Fund")**

We have audited the accompanying financial statements of the Fund, which comprise the statements of financial position as at August 31, 2017 and August 31, 2016, and the statements of comprehensive income, changes in net assets attributable to holders of redeemable shares, and cash flows for the years ended August 31, 2017 and 2016, and a summary of significant accounting policies and other explanatory information.

**Management's Responsibility for the Financial Statements**

Management is responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

**Auditors' Responsibility**

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

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

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

**Opinion**

In our opinion, the financial statements present fairly, in all material respects, the financial position of the Fund as at August 31, 2017 and August 31, 2016, and its financial performance and cash flows for the years then ended in accordance with International Financial Reporting Standards.

Toronto, Canada  
November 10, 2017

The logo for Ernst & Young LLP, featuring the company name in a stylized, handwritten-style script.

Chartered Professional Accountants  
Licensed Public Accountants

STATEMENTS OF FINANCIAL POSITION

[in \$ thousands of Canadian dollars, except per share amounts and number of shares]

| As at   | August 31, 2017<br>\$ | August 31, 2016<br>\$ |
|---|-----------------------|-----------------------|
| <b>ASSETS AND LIABILITIES</b>   |                       |                       |
| <b>Assets</b>   |                       |                       |
| Cash  | 3,602                 | 15,428                |
| Restricted cash [Note 5]  | -                     | 3,090                 |
| Venture investments, at fair value  | 91,442                | 119,436               |
| Receivable for investments sold   | 1,887                 | 8,300                 |
| Interest and dividend receivable  | 63                    | 57                    |
|   | <b>96,994</b>         | <b>146,311</b>        |
| <b>Liabilities</b>  |                       |                       |
| Accounts payable and accrued liabilities  | 4,014                 | 1,457                 |
| Conditional incentive participation amount payable [Note 8]                       | 670                   | 4,024                 |
|   | <b>4,684</b>          | <b>5,481</b>          |
| <b>Net assets attributable to holders of redeemable shares</b>                    | <b>92,310</b>         | <b>140,830</b>        |
| <b>Net assets attributable to holders of redeemable shares per Series</b>         |                       |                       |
| Class A, Series I   | \$ 56,758             | \$ 84,636             |
| Class A, Series II  | \$ 35,552             | \$ 56,194             |
| <b>Redeemable Class A Shares outstanding [Note 6]</b>                             |                       |                       |
| Class A, Series I   | 10,165,503            | 12,385,692            |
| Class A, Series II  | 6,699,307             | 8,645,176             |
| <b>Net assets attributable to holders of redeemable shares per share [Note 6]</b> |                       |                       |
| Class A, Series I   | \$ 5.58               | \$ 6.83               |
| Class A, Series II  | \$ 5.31               | \$ 6.50               |

On behalf of the Board of Directors:



Henry J. Pankratz  
Director



Terrence B. Kulka  
Director

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

**STATEMENTS OF COMPREHENSIVE INCOME**

[in \$ thousands of Canadian dollars, except per share amounts and number of shares]

| <b>For the years ended August 31,</b>  | <b>2017</b>     | 2016            |
|--|-----------------|-----------------|
|  | \$              | \$              |
| <b>INCOME</b>  |                 |                 |
| Net gain/(loss) on financial instruments:  |                 |                 |
| Interest for distribution purposes   | 253             | 7,340           |
| Fee income from venture investments  | 988             | -               |
| Dividends  | -               | 16,948          |
| Escrow recovery  | -               | 2,755           |
| Realized gain/(loss) on sale of investments <sup>1</sup>   | 4,662           | (32,575)        |
| Realized loss on foreign exchange  | (119)           | (17)            |
| Change in unrealized depreciation of marketable securities   | -               | (27)            |
| Change in unrealized depreciation of venture investments   | (18,958)        | (16,460)        |
| Other income   | -               | 5               |
|  | <b>(13,174)</b> | <b>(22,031)</b> |
| <b>EXPENSES</b>  |                 |                 |
| VenGrowth contract amount [Note 8]   | 1,555           | 2,260           |
| Management fees [Note 8]   | 1,500           | 2,181           |
| Other  | 834             | (897)           |
| Service fees [Note 8]  | 521             | 789             |
| Fund administrator fees [Note 8]   | 500             | 732             |
| Write-down of escrow receivable  | 485             | -               |
| Contingent incentive participation amount [Note 8]   | 460             | 1,612           |
| Harmonized Sales Taxes   | 439             | 628             |
| Directors fees   | 332             | 361             |
| Shareholder communications   | 285             | 342             |
| Audit fees   | 240             | 246             |
| Loan fee and interest [Note 10]  | 238             | -               |
| Sponsor fees [Note 8]  | 178             | 259             |
| Custody fees   | 37              | 44              |
| Capital maintenance payment [Note 8]   | 25              | 149             |
| Independent Review Committee   | 23              | 25              |
| Legal fees   | 16              | 26              |
|  | <b>7,668</b>    | <b>8,757</b>    |
| <b>Decrease in net assets attributable to holders of redeemable shares</b>   | <b>(20,842)</b> | <b>(30,788)</b> |
| <b>Decrease in net assets attributable to holders of redeemable shares per Series</b>  |                 |                 |
| Class A, Series I  | (12,764)        | (18,506)        |
| Class A, Series II   | (8,078)         | (12,282)        |
| <b>Decrease in net assets attributable to holders of redeemable shares per share</b><br>(based on weighted average number of shares outstanding) |                 |                 |
| Class A, Series I  | \$ (1.21)       | \$ (1.40)       |
| Class A, Series II   | \$ (1.15)       | \$ (1.33)       |
| <b>Weighted average number of shares outstanding</b>   |                 |                 |
| Class A, Series I  | 10,546,747      | 13,252,064      |
| Class A, Series II   | 7,031,080       | 9,203,124       |

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

STATEMENTS OF COMPREHENSIVE INCOME [Cont'd]

[in \$ thousands of Canadian dollars]

| For the years ended August 31,                                   | 2017<br>\$   | 2016<br>\$      |
|--|--------------|-----------------|
| <b>Breakdown of realized gain/(loss) on sale of investments:</b> |              |                 |
| <b>Marketable securities</b>                                     |              |                 |
| Equities, at cost, beginning of year                             | -            | 3,501           |
| Equities purchased during the year                               | -            | -               |
|  | -            | 3,501           |
| Equities, at cost, end of year                                   | -            | -               |
| Cost of equities sold  | -            | 3,501           |
| Proceeds from sale of equities                                   | -            | 3,397           |
| Realized gain/(loss) on sale of equities                         | -            | (104)           |
| <b>Venture investments</b>                                       |              |                 |
| Venture investments, at cost, beginning of year                  | 165,412      | 222,966         |
| Venture investments purchased during the year                    | 4,281        | 59,881          |
| Venture investments repaid during the year                       | (6,576)      | (19,122)        |
|  | 163,117      | 263,725         |
| Venture investments, at cost, end of year                        | 156,376      | 165,412         |
| Cost of venture investments sold                                 | 6,741        | 98,313          |
| Proceeds from sale of venture investments                        | 11,403       | 65,842          |
| Realized gain/(loss) on sale of venture investments              | 4,662        | (32,471)        |
| <b>Realized gain/(loss) on sale of investments</b>               | <b>4,662</b> | <b>(32,575)</b> |

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

STATEMENTS OF CHANGES IN NET ASSETS ATTRIBUTABLE TO HOLDERS OF REDEEMABLE SHARES

[in \$ thousands of Canadian dollars]

| For the years ended August 31,  | 2017<br>\$    | 2016<br>\$     |
|---|---------------|----------------|
| <b>Net assets attributable to holders of redeemable shares, beginning of year</b> |               |                |
| Series I  | 84,636        | 127,748        |
| Series II   | 56,194        | 86,840         |
| <b>Decrease in net assets attributable to holders of redeemable shares</b>        |               |                |
| Series I  | (12,764)      | (18,506)       |
| Series II   | (8,078)       | (12,282)       |
| <b>Amounts paid for Class A shares redeemed</b>                                   |               |                |
| Series I  | (15,114)      | (24,606)       |
| Series II   | (12,564)      | (18,364)       |
| <b>Net assets attributable to holders of redeemable shares, end of year</b>       | <b>92,310</b> | <b>140,830</b> |

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

**STATEMENTS OF CASH FLOWS**

[in \$ thousands of Canadian dollars]

| <b>For the years ended August 31,</b>                               | <b>2017</b>     | 2016     |
|---|-----------------|----------|
|   | <b>\$</b>       | \$       |
| <b>Operating activities</b>   |                 |          |
| Decrease in net assets attributable to holders of redeemable shares | <b>(20,842)</b> | (30,788) |
| Items not affecting cash:   |                 |          |
| Realized (gain)/loss on sale of investments                         | <b>(4,662)</b>  | 32,575   |
| Change in unrealized depreciation of investments                    | <b>18,958</b>   | 16,487   |
| Fee income from venture investments [Note 5]                        | -               | (6,790)  |
| Purchase of venture investments                                     | <b>(4,281)</b>  | (20,539) |
| Repayment of venture debt   | <b>6,576</b>    | 19,122   |
| Proceeds from sale of equities                                      | -               | 3,397    |
| Proceeds from sale of venture investments                           | <b>11,403</b>   | 33,291   |
| Decrease/(increase) in restricted cash [Note 5]                     | <b>3,090</b>    | (3,090)  |
| Change in non-cash working capital:                                 |                 |          |
| Change in other assets and liabilities                              | <b>5,610</b>    | (3,101)  |
|   | <b>15,852</b>   | 40,564   |
| <b>Financing activities</b>   |                 |          |
| Amounts paid for Class A Shares redeemed, Series I and II           | <b>(27,678)</b> | (43,087) |
|   | <b>(27,678)</b> | (43,087) |
| <b>Decrease in cash during the year</b>                             | <b>(11,826)</b> | (2,523)  |
| Cash, beginning of year   | <b>15,428</b>   | 17,951   |
| <b>Cash, end of year</b>  | <b>3,602</b>    | 15,428   |
| <b>Non-monetary transactions [Note 7]</b>                           |                 |          |
| Securities received from debt financing and share exchange          | -               | 39,342   |
| Proceeds from share exchange  | -               | 32,551   |
| <b>Supplementary information:</b>                                   |                 |          |
| Dividends received*   | -               | 16,948   |
| Interest received*  | <b>253</b>      | 7,340    |

\* included in operating activities

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

**SCHEDULE OF INVESTMENT PORTFOLIO**

[in \$ thousands of Canadian dollars, except number of shares or par value \$]

**As at August 31, 2017**
**Venture investments**

| Investee companies   | Number of shares<br>(or par value \$) | Debt at cost<br>\$ | Equity at cost<br>\$ | Total<br>\$ |
|--|---------------------------------------|--------------------|----------------------|-------------|
| Active Exhaust Corporation, Class B Common   | 502,766                               | -                  | 822                  | 822         |
| AppZero Software Corporation, Common   | 1,096,138                             | -                  | 874                  | 874         |
| AppZero Software Corporation, Class A Preferred  | 1,988,252                             | -                  | 2,217                | 2,217       |
| Axela Inc., Demand Debenture, 8%   | \$12,865,533                          | 11,567             | -                    | 11,567      |
| Axela Inc., Demand Debenture, 12%  | \$15,637,046                          | -                  | -                    | -           |
| Axela Inc., Demand Debenture, 15%  | \$11,463,030                          | -                  | -                    | -           |
| Axela Inc., Demand Debenture, 20%  | \$5,888,024                           | -                  | -                    | -           |
| Axela Inc., Demand Convertible Debenture, 12%  | \$14,736,000                          | 14,736             | -                    | 14,736      |
| Axela Inc., Demand Promissory Note, 12%  | \$3,095,891                           | 3,096              | -                    | 3,096       |
| Axela Inc., Common   | 1,313,244                             | -                  | -                    | -           |
| Axela Inc., Class A Series 1 Preferred   | 13,442,856                            | -                  | -                    | -           |
| Axela Inc., Class A Series 2 Preferred   | 606,647                               | -                  | -                    | -           |
| Axela Inc., Class A Series 3 Preferred   | 2,065,936                             | -                  | -                    | -           |
| Axela Inc., Class A Preferred  | 7,858,299                             | -                  | -                    | -           |
| bitHeads Inc., Demand Promissory Note, Prime +1/2%                                     | \$135,000                             | 98                 | -                    | 98          |
| Black Bull Resources Inc., Common†   | 51,666                                | -                  | 6                    | 6           |
| Clek Inc., Class B Common*   | 2,681,674                             | -                  | 5,458                | 5,458       |
| Embotics Corporation, Class A Preferred  | 395,958                               | -                  | 3,579                | 3,579       |
| Embotics Corporation, Class B-2 Preferred  | 698,509                               | -                  | 2,500                | 2,500       |
| Fidelity PAC Metals Ltd., Demand Promissory Note, 6%                                   | \$285,623                             | 286                | -                    | 286         |
| Fidelity PAC Metals Ltd, Common  | 2,060,000                             | -                  | 2,060                | 2,060       |
| Fusebill Inc., Seed Preference   | 3,025,705                             | -                  | 1,315                | 1,315       |
| Fusebill Inc., Common  | 694,580                               | -                  | 300                  | 300         |
| Greenfield Ethanol Inc., Milestones  | 621,327                               | -                  | -                    | -           |
| Interface Biologics Inc., Class A Preferred  | 10,882,956                            | -                  | 17,473               | 17,473      |
| Ivey CSBIF I Inc. Class A  | 250,000                               | -                  | 2,000                | 2,000       |
| Ivey CSBIF II Inc. Class A   | 250,000                               | -                  | 2,000                | 2,000       |
| Mist Mobility Integrated Systems Technology Inc.,<br>Demand Promissory Note, 12%       | \$14,000,000                          | 12,950             | -                    | 12,950      |
| Mist Mobility Integrated Systems Technology Inc.,<br>Demand Debenture, 15%             | \$750,000                             | 750                | -                    | 750         |
| Mist Mobility Integrated Systems Technology Inc.,<br>Demand Subordinated Debenture, 5% | \$2,250,000                           | 2,250              | -                    | 2,250       |
| Mist Mobility Integrated Systems Technology Inc., Common                               | 6,969,216                             | -                  | 2,250                | 2,250       |

**SCHEDULE OF INVESTMENT PORTFOLIO [Cont'd]**

[in \$ thousands of Canadian dollars, except number of shares or par value \$]

**Venture investments (cont.'d.)**

| Investee companies  | Number of shares<br>(or par value \$) | Debt at cost<br>\$ | Equity at cost<br>\$ | Total<br>\$    |
|---|---------------------------------------|--------------------|----------------------|----------------|
| Nakina Systems Inc., Class A Common*  | 6,168,948                             | -                  | -                    | -              |
| Nakina Systems Inc., Class A Preferred*   | 10,909,081                            | -                  | -                    | -              |
| Nakina Systems Inc., Class B Preferred*   | 8,271,130                             | -                  | -                    | -              |
| Nakina Systems Inc., Class C Preferred*   | 39,167,338                            | -                  | 4,645                | 4,645          |
| Nakina Systems Inc., Senior Shares  | 19,490,946                            | -                  | 2,338                | 2,338          |
| Nakina Systems Inc., Warrants*  | 11,133,110                            | -                  | 444                  | 444            |
| OTYC Holdings Inc., Class D Preferred   | 43,192,955                            | -                  | 6,820                | 6,820          |
| OTYC Holdings Inc., Milestones  | 17,301,627                            | -                  | -                    | -              |
| PowerBand Global Inc., Common   | 169,982                               | -                  | 8,446                | 8,446          |
| PowerBand Global Inc., Demand Promissory Note, 7%   | \$3,512,997                           | 3,513              | -                    | 3,513          |
| PowerBand Global Inc., Demand Promissory Note, 12%  | \$1,910,000                           | 1,910              | -                    | 1,910          |
| PowerBand Global Inc., Demand Debenture, 24%  | \$2,063,376                           | 2,063              | -                    | 2,063          |
| Simex Inc., Series A Preferred  | 58,871                                | -                  | -                    | -              |
| Spartan Bioscience Inc., Common   | 2,010,000                             | -                  | 231                  | 231            |
| VG Mezzanine I Limited Partnership  | 13,590                                | -                  | 1,302                | 1,302          |
| WireIE Holdings International Inc., Secured Convertible Debenture,<br>10%, due March 13, 2018 | \$4,750,000                           | 4,750              | -                    | 4,750          |
| WireIE Holdings International Inc., Demand Promissory Note, 12%                               | \$23,265,000                          | 23,265             | -                    | 23,265         |
| WireIE Holdings International Inc., Common  | 28,244,887                            | -                  | 8,062                | 8,062          |
| WireIE Holdings International Inc., Preferred   | 1                                     | -                  | -                    | -              |
| <b>Total venture investments, at cost</b>   |                                       | 81,234             | 75,142               | <b>156,376</b> |
| Unrealized appreciation/(depreciation) of venture investments                                 |                                       |                    |                      | (64,934)       |
| <b>Venture investments, at fair value</b>   |                                       |                    |                      | <b>91,442</b>  |
| <b>Total investments, at fair value</b>   |                                       |                    |                      | <b>91,442</b>  |
| Other assets, net of liabilities  |                                       |                    |                      | 868            |
| <b>Net assets attributable to holders of redeemable shares</b>                                |                                       |                    |                      | <b>92,310</b>  |

\* Investment made and tracked in US dollars.

† Indicates a publicly traded security.

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

**SCHEDULE OF INVESTMENT PORTFOLIO [Cont'd]**

[in \$ thousands of Canadian dollars, except percentages and number of companies]

|                               | <b>Number of<br/>companies</b> | <b>Cost of<br/>investments<br/>\$</b> | <b>% Total venture<br/>investments<br/>at cost<br/>%</b> | <b>Fair value of<br/>investments<br/>\$</b> | <b>% Total venture<br/>investments<br/>at fair value<br/>%</b> |
|-------------------------------|--------------------------------|---------------------------------------|--|---|--|
| <b>As at August 31, 2017</b>  |                                |                                       |  |   |  |
| <b>Stage of Development</b>   |                                |                                       |  |   |  |
| Start-Up/Early                | 6                              | 77,407                                | 49.5   | 50,909                                      | 55.7   |
| Expansion                     | 12                             | 70,240                                | 44.9   | 37,209                                      | 40.7   |
| Later                         | 3                              | 8,729                                 | 5.6  | 3,324                                       | 3.6  |
|                               | <b>21</b>                      | <b>156,376</b>                        | <b>100.0</b>   | <b>91,442</b>                               | <b>100.0</b>   |
| <b>Industry Class</b>         |                                |                                       |  |   |  |
| Biotechnology/Health Sciences | 4                              | 53,923                                | 34.5   | 25,883                                      | 28.3   |
| Financial Services            | 3                              | 5,302                                 | 3.4  | 4,573                                       | 5.0  |
| Technology                    | 9                              | 71,141                                | 45.5   | 35,085                                      | 38.4   |
| Manufacturing/Distribution    | 5                              | 26,010                                | 16.6   | 25,901                                      | 28.3   |
|                               | <b>21</b>                      | <b>156,376</b>                        | <b>100.0</b>   | <b>91,442</b>                               | <b>100.0</b>   |
| <b>As at August 31, 2016</b>  |                                |                                       |  |   |  |
| <b>Stage of Development</b>   |                                |                                       |  |   |  |
| Start-Up/Early                | 6                              | 77,022                                | 46.6   | 56,865                                      | 47.6   |
| Expansion                     | 17                             | 75,776                                | 45.8   | 55,565                                      | 46.5   |
| Later                         | 5                              | 12,614                                | 7.6  | 7,006                                       | 5.9  |
|                               | <b>28</b>                      | <b>165,412</b>                        | <b>100.0</b>   | <b>119,436</b>                              | <b>100.0</b>   |
| <b>Industry Class</b>         |                                |                                       |  |   |  |
| Biotechnology/Health Sciences | 5                              | 50,027                                | 30.3   | 30,565                                      | 25.6   |
| Financial Services            | 4                              | 7,495                                 | 4.5  | 7,484                                       | 6.3  |
| Technology                    | 12                             | 76,360                                | 46.2   | 52,722                                      | 44.1   |
| Manufacturing/Distribution    | 7                              | 31,530                                | 19.0   | 28,665                                      | 24.0   |
|                               | <b>28</b>                      | <b>165,412</b>                        | <b>100.0</b>   | <b>119,436</b>                              | <b>100.0</b>   |

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

AUGUST 31, 2017

[In \$ thousands of Canadian dollars, except per share amounts and number of shares]

## 1. CORPORATE STATUS AND ACTIVITIES

---

Covington Fund II Inc. (the “Fund”), originally incorporated under the laws of Ontario on September 20, 1999, was continued under the Canada Business Corporations Act effective November 29, 2010. The Fund is registered as a Labour-Sponsored Investment Fund Corporation (“LSIF”) under the Community Small Business Investment Funds Act (Ontario) (the “Ontario Act”) and as a Labour-Sponsored Venture Capital Corporation (“LSVCC”) under the Income Tax Act (Canada) (the “Act”). The address of the Fund’s registered office is 36 Distillery Lane, Suite 440, Toronto, Ontario M5A 3C4. These financial statements were authorized for issue by the Fund’s Board of Directors on November 10, 2017.

The investment objective of the Fund is to earn long term capital appreciation on part of its investment portfolio and current yield and early return of capital on the remainder of its investment portfolio.

The Manager of the Fund is Covington Capital Corporation (“Covington” or the “Manager”). The administrator of the Fund is CI Investments Inc. (the “Fund Administrator”). The Fund has two Co-Sponsors, the Canadian Police Association (“CPA”) and the Association of Canadian Financial Officers (“ACFO”) (the “Co-Sponsors”).

The Fund is currently closed to new subscriptions. Redemptions of the Fund have been temporarily halted. See Note 6.

## 2. BASIS OF PRESENTATION

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These financial statements have been prepared in compliance with International Financial Reporting Standards (“IFRS”) published by the International Accounting Standards Board (“IASB”).

The financial statements have been prepared on a going concern basis using the historical-cost convention. However, the Fund is an investment entity and primarily all financial assets and financial liabilities are measured at fair value in accordance with IFRS. Accordingly, the Fund’s accounting policies for measuring the fair value of investments and derivatives are consistent with those used in measuring the Net Asset Value for transactions with unitholders. In applying IFRS, these financial statements include estimates and assumptions made by management that affect the reported amounts of assets, liabilities, income, and expenses during the reporting periods. However, existing circumstances and assumptions may change due to market changes or circumstances arising beyond the control of the Fund. Such changes are reflected in the assumptions when they occur.

These financial statements are presented in Canadian dollars, which is the Fund’s functional currency.

## 3. SIGNIFICANT ACCOUNTING POLICIES

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### Financial instruments

The Fund recognizes financial instruments at fair value upon initial recognition, inclusive of transaction costs in the case of financial instruments measured at amortized cost. Purchases and sales of financial assets are recognized at their trade date. The Fund’s investments and liabilities are measured at fair value through profit or loss (“FVTPL”). The Fund’s obligations for net assets attributable to holders of redeemable shares are presented at the redemption amount. All other financial assets and liabilities, such as accounts receivable, receivables for venture investments sold, income receivables, accounts payable, accrued expenses, conditional incentive participation amounts payable and redemptions payable, are measured at amortized cost, which approximates fair value due to their short term nature. Under this method, financial assets and liabilities reflect the amount required to be received or paid, discounted, when appropriate, at the contract’s stated rates of interest.

### Valuation of investments

At the financial reporting date, all investments having quoted market values and which are publicly traded on a recognized stock exchange, and are not otherwise restricted, are valued based on the last traded market price for financial assets and financial liabilities where the last traded price falls within the day’s bid-ask spread. In circumstances where the last traded price is not within the bid-ask spread, the Manager determines the point within the bid-ask spread that is most representative of fair value based on the existing market conditions. The changes in fair value are recorded as unrealized appreciation (depreciation) of marketable securities.

AUGUST 31, 2017

[In \$ thousands of Canadian dollars, except per share amounts and number of shares]

### 3. SIGNIFICANT ACCOUNTING POLICIES (Cont'd)

Fixed income securities, debentures or other debt instruments, including short-term investments, are valued at the quotation price from recognized investment dealers.

Venture investments in securities not having quoted market values or in restricted securities are recorded at estimated fair value ("FV"). The fair values of the venture investments are determined by the Manager using recognized valuation methodology after considering: the history and nature of the business; operating results and financial conditions; the general economic, industry and market conditions; capital market and transaction market conditions; independent valuations of the business; contractual rights relating to the investment; comparable company trading and transaction multiples, where applicable, and other pertinent considerations.

For warrants that are not traded on a recognized securities exchange, where no market value is readily available, a valuation technique is used by maximizing the use of observable market inputs.

The process of valuing venture investments for which no published market exists is subject to inherent uncertainties and the resulting values may differ from values that would have been used had a ready market existed for the investments.

#### Financial assets and liabilities at fair value

The Fund carries its investment in equity and debt as financial assets or financial liabilities at FVTPL. This has two sub-categories: (1) financial assets or financial liabilities held for trading; and (2) those designated as FVTPL at inception.

- (1) Financial assets and financial liabilities held for trading: a financial asset or financial liability is classified as held for trading ("HFT") if it is acquired or incurred principally for the purpose of selling or repurchasing in the near term or if on initial recognition, it is part of a portfolio of identifiable financial instruments that are managed together and for which there is evidence of a recent actual pattern of short term profit taking.
- (2) Financial assets and financial liabilities designated as FVTPL: financial assets or financial liabilities designated as FVTPL at inception, are financial instruments that are not classified as HFT but are managed and their performance is evaluated on a fair value basis in accordance with the Fund's documented investment strategy. The Fund's investments are designated as FVTPL.

#### Investment entity

Under Investment Entities – Amendments to IFRS 10, the Fund has determined that it meets the definition of an investment entity under IFRS 10, Consolidated Financial Statements, in that it obtains funds from one or more investors for the purpose of providing them with investment management services, commits to its investors that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or both, and measures and evaluates the performance of substantially all of its investments on a fair value basis. Consequently, the Fund measures investments in other entities over which it has control, at FVTPL, and consolidates only those subsidiaries that provide services related to the Fund's investment activities, if any.

#### Subsidiaries, associates, joint ventures and structured entities

Subsidiaries are entities, including investments in other investment entities, over which a Fund has control. A Fund controls an entity when it is exposed to, or has rights to, variable returns from its involvement with the entity, and has the ability to affect those returns through its power over the entity. Associates and joint ventures are investments over which a Fund has significant influence or joint control. A structured entity is an entity that has been designed so that voting or similar rights are not the dominant factors in deciding who controls the entity, or when voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements.

AUGUST 31, 2017

[In \$ thousands of Canadian dollars, except per share amounts and number of shares]

**3. SIGNIFICANT ACCOUNTING POLICIES (Cont'd)**

IFRS 10, Consolidated Financial Statements, establishes principles for consolidation when one entity controls another but allows an exemption for the consolidation of subsidiaries of investment entities and requires such entities to recognize all subsidiaries at fair value through profit and loss. IAS 28, Investment in Associates, also allows investments in associates that are held by investment entities to be recognized and measured at fair value through profit and loss and to be accounted for in accordance with IAS 39, Financial Instruments: Recognition and Measurement and IFRS 13, Fair Value Measurement, with changes in fair value recognized in the Statements of Comprehensive Income in the period of change. As such, investments that are held as part of the Fund's investment portfolio are carried on the Statements of Financial Position at fair value even though the Fund may have control or significant influence over those companies. Investments in unconsolidated structured entities, if any, have been designated at FVTPL.

**Income recognition and security holder transactions**

Interest and income for distribution purposes and other income are recorded on an accrual basis. Dividend income is recognized on the ex-dividend date. Investment transactions are accounted for on a trade date basis and gains and losses from such transactions are calculated based on average cost excluding transaction costs. Net realized and unrealized gains (losses) on investments include the related foreign exchange gains and losses in the Statements of Comprehensive Income.

**Commissions and other portfolio transaction costs**

Transaction costs, such as brokerage commissions, if any, incurred in the purchase and sale of securities are included in "Other" in the Statements of Comprehensive Income.

**Allocation of income and expenses**

The Fund allocates income, expenses, realized and unrealized gains (losses) on the following basis: Income, realized and unrealized gains (losses) are apportioned on a weekly basis based on the net asset value ("NAV") of the respective Series to the total net asset value of the Fund as at the most recent valuation date.

Expenses are categorized and tracked as expenses directly attributable to a specific Series ("direct expenses") and those that are common expenses of the Fund. Direct expenses of a particular Series are recorded as a direct expense to that Series. Common expenses are allocated to each Series in a consistent manner as the income allocation described above.

**Foreign currency translation**

The Fund holds certain venture investments where the original purchase price was stated in US dollars. The cost is converted to Canadian dollars at the exchange rate in effect at the time of purchase and this amount becomes the historical cost of the investment. When a venture investment was purchased in US dollars, the fair value of these investments are adjusted weekly for the change in the exchange rate.

**Increase (decrease) in net assets attributable to holders of redeemable shares**

Increase (decrease) in net assets attributable to holders of redeemable shares per series of Class A Share in the Statements of Comprehensive Income is calculated by dividing the increase (decrease) in net assets attributable to holder of redeemable shares per series by the weighted average number of shares outstanding for the relevant series of Class A Share during the year.

**Receivable for investments sold**

Receivable for investments sold are carried at fair value. Receivable for investments sold are considered impaired when there is objective evidence that the full carrying value of the receivable is not collectible. When an impairment is identified, the carrying amount of the receivable is reduced to its estimated realizable amount. The excess of carrying value over the estimated net realizable value of the receivable represents an impairment loss which is recognized in the Statements of Comprehensive Income. If the amount of an impairment loss decreases in a subsequent period, and the decrease can be related objectively to an event occurring after the impairment was recognized, any reversal of impairment is recognized in the current period Statements of Comprehensive Income. For the 2017 fiscal year, the Company recognized a writedown of escrow receivable of (\$485) (2016 - escrow recovery of \$2,755).

## NOTES TO FINANCIAL STATEMENTS

AUGUST 31, 2017

[In \$ thousands of Canadian dollars, except per share amounts and number of shares]

### 4. CRITICAL ACCOUNTING ESTIMATES AND JUDGEMENTS

The preparation of financial statements requires the Manager to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates and the differences could be material.

The most significant accounting judgements and estimates that the Fund has made preparing the financial statements are:

- (1) Fair value of venture investments in securities not having quoted market values – The Fund holds some investments that are not quoted on a recognized stock exchange. Such unlisted securities may be valued based on price quotations from recognized investment dealers, or if not available, determined by the Manager using valuation methodologies and considerations as described in Note 3. The process of valuing venture investments for which no published market exists is subject to inherent uncertainties and the resulting values may differ from values that would have been used had a ready market existed for the investments.
- (2) Classification and measurement of investments and application of the fair value option – In classifying and measuring the financial instruments held by the Fund, the Manager is required to make significant judgements about whether or not the business of the Fund is to invest on a total return basis for the purpose of applying the fair value option for financial assets under IAS 39, Financial Instruments – Recognition and Measurement. The most significant judgement includes the determination that the fair valuation option can be applied to the Fund's investments.

### 5. UNCONSOLIDATED SUBSIDIARIES, ASSOCIATES AND STRUCTURED ENTITIES

The Fund meets the definition of an investment entity. Therefore, it does not consolidate its subsidiaries but rather, recognizes them as investments at fair value through profit and loss. The following represent the Fund's interest in unconsolidated subsidiaries, associates and structured entities and related ownership percentages:

| Name   | Relationship | August 31, 2017                           | Relationship | August 31, 2016                           |
|--|--------------|---|--------------|---|
|  |              | Proportion of ownership and voting rights |              | Proportion of ownership and voting rights |
| 2210961 Ontario Ltd.                             | -            | -   | Subsidiary   | 50%                                       |
| Axela Inc.                                       | Subsidiary   | 79%                                       | Subsidiary   | 79%                                       |
| Bitheads Inc.                                    | -            | -   | Associate    | 25%                                       |
| Clek Inc.  | Associate    | 35%                                       | Associate    | 35%                                       |
| Fidelity PAC Metals Ltd.                         | Subsidiary   | 50%                                       | Subsidiary   | 50%                                       |
| Fusebill Inc.                                    | -            | -   | Associate    | 22.6%                                     |
| Interface Biologics Inc.                         | Associate    | 44%                                       | Associate    | 45%                                       |
| Ivey CSBIF I Inc.                                | Subsidiary   | 53%                                       | Subsidiary   | 53%                                       |
| Ivey CSBIF II Inc.                               | Subsidiary   | 53%                                       | Subsidiary   | 53%                                       |
| Masstech Innovations Inc.                        | -            | -   | Subsidiary   | 89%                                       |
| Mist Mobility Integrated Systems Technology Inc. | Associate    | 30%                                       | Associate    | 30%                                       |
| Nakina Systems Inc.                              | Associate    | 40%                                       | Associate    | 40%                                       |
| OTYC Holdings Inc.                               | Associate    | 21%                                       | Associate    | 21%                                       |
| Powerband Global Inc.                            | Subsidiary   | 51%                                       | Subsidiary   | 51%                                       |
| Roll-Tite Inc.                                   | -            | -   | Subsidiary   | 85%                                       |
| VG Mezzanine I Limited Partnership               | Associate    | 36%                                       | Associate    | 36%                                       |
| WireIE Holdings International Inc.               | Subsidiary   | 70%                                       | Subsidiary   | 70%                                       |

The entities listed above are incorporated in Canada and have their principal place of business in Canada.

**AUGUST 31, 2017**

[In \$ thousands of Canadian dollars, except per share amounts and number of shares]

**5. UNCONSOLIDATED SUBSIDIARIES, ASSOCIATES AND STRUCTURED ENTITIES (Cont'd)**

**Restrictions**

The Fund may receive income in the form of dividends or interest from its investments in unconsolidated subsidiaries. While there are no significant restrictions on the transfer of funds from these entities to the Fund, they may be subject to Board of Directors approvals at the subsidiary level as required in any of the subsidiaries' shareholder agreements or other documents.

**Commitments and Restricted Cash**

In 2016, the Fund had provided a guarantee to Axela Inc. in the amount of \$3,090 in support of a credit facility. In lieu of calling the guarantee, the lender required the Fund to deposit \$3,090 into a restricted cash account. During 2017, these funds were drawn from the restricted cash account and the amount was recorded as a follow-on investment in Axela.

Additionally the Fund has provided a guarantee of \$1,511 (2016 - \$4,250) to Clek Inc. in support of a credit facility. Should the guarantee be drawn, the amount would be recorded as a follow-on investment.

**Support**

During the year, the Fund completed follow-on financings to support its unconsolidated subsidiaries as follows:

| <b>Company</b>           | <b>Financings completed</b>   |
|--------------------------|---|
| Axela Inc.               | \$3,896 (2016 - \$625) in 12% demand promissory notes and demand convertible debentures |
| Powerband Global Inc.    | \$195 (2016 - \$290) in 12% demand promissory notes                                     |
| WireE International Inc. | \$190 (2016 - \$19,325) in 12% demand promissory notes                                  |

**6. REDEEMABLE SHARES**

The Fund has specific capital requirements and restrictions as outlined in the Fund's annual information form. The Fund's Statements of Changes in Net Assets Attributable to Holders of Redeemable Shares identify changes in the Fund's capital during the period. The Manager manages the capital of the Fund in accordance with the Fund's investment objective; including managing its liquidity in order to meet redemptions. The Fund is authorized to issue an unlimited number of Class A Shares in an unlimited number of series.

The Fund is registered as an LSIF under the Ontario Act, is an LSVCC under the Act and is required to invest a portion of capital raised in eligible small and medium sized Canadian businesses. Eligible businesses are generally privately owned and are characterized as having less than \$50 million in assets and less than 500 employees. In order to be classified as eligible investments, there are restrictions under the Act on the size, nature, and timing of the investments as outlined in the Fund's annual information form. These restrictions, if not met, could have negative impacts as the Fund could be levied with penalty taxes and, ultimately, have its LSIF status revoked. As at December 31, 2016, the Fund was in compliance with these restrictions related to both the Act and Ontario Act.

The following is a description of the authorized and issued share capital:

Unlimited number of Class A Shares, issuable from treasury, discretionary dividend entitlement, voting, restrictions on transfer and redemption, entitled to elect two directors.

25,000 Class B shares issuable only to the Co-Sponsors of the Fund, no dividend entitlement, voting entitled to elect remainder of directors.

Unlimited number of Class C shares, issuable in series. None issued or outstanding.

100 Class D Shares, voting, no dividend entitlement, redeemed upon issuance of Class B shares. None outstanding.

## NOTES TO FINANCIAL STATEMENTS

AUGUST 31, 2017

[In \$ thousands of Canadian dollars, except per share amounts and number of shares]

### 6. REDEEMABLE SHARES (Cont'd)

#### Issued and Outstanding of Class A Shares

The following shares were issued and redeemed during the years indicated:

| For the year ended August 31, 2017 | Class A, Series I | Class A, Series II |
|------------------------------------|-------------------|--------------------|
| Balance, beginning of year         | 12,385,692        | 8,645,176          |
| Redeemed during the year           | (2,220,189)       | (1,945,869)        |
| Balance, end of year               | 10,165,503        | 6,699,307          |

  

| For the year ended August 31, 2016 | Class A, Series I | Class A, Series II |
|------------------------------------|-------------------|--------------------|
| Balance, beginning of year         | 15,655,888        | 11,166,508         |
| Redeemed during the year           | (3,270,196)       | (2,521,332)        |
| Balance, end of year               | 12,385,692        | 8,645,176          |

#### Redemption of Class A Shares

A shareholder may redeem all or part of the Class A Shares held at the NAV per Class A Share, subject to certain restrictions. One of these restrictions provides that the Fund is not required to redeem Class A Shares, in any financial year having an aggregate redemption price exceeding 20% of the NAV of the Fund as at the last day of the preceding fiscal year. The Fund cannot guarantee that it will be able to honour all redemption requests on the day in which they are made. Some of the Fund's investments are held in non-liquid securities. As such, if all shareholders were to redeem their shares at the same time, the Fund may need to liquidate these investments at lower values than currently ascribed and shareholders may not receive the NAV ascribed. The redemption of Class A Shares may be suspended in certain circumstances as permitted by applicable securities law.

On September 2, 2011, the Fund merged (the "Merger") with the New Generation Biotech (Equity) Fund Inc. ("NGBE"), The Vengrowth Investment Fund Inc., The Vengrowth II Investment Fund Inc., The Vengrowth III Investment Fund Inc., The Vengrowth Advanced Life Sciences Fund Inc., and The Vengrowth Traditional Industries Fund Inc. (collectively the "Merged Funds"). Pursuant to this transaction, the Fund acquired all of the assets and assumed the liabilities of the Merged Funds at fair value in exchange for units of the Fund based on the exchange ratio established on closing. At the time of the Merger, shareholders of the Merging Funds receiving Class A Shares, Series I or Series II had an option to redeem shares received pursuant to the merger. These redemptions were subject to a 15% redemption fee payable as income to the Fund.

Class A Shares, Series I and Series II issued pursuant to the merger to shareholders of the Merging Funds that did not redeem at the time of the transaction, were subject to additional redemption restrictions. Shareholders were able to redeem 15% per year of the shares they received on the effective date of the merger without redemption fees. This 15% restriction was in effect for four years and was not cumulative from one year to the next.

On September 2, 2015, the fourth anniversary of the Merger, the redemption restriction expired on all Class A Shares that have been issued and outstanding for eight years or more. On September 8, 2015, the Fund announced a temporary halt to redemptions of the Fund given the magnitude of redemption requests had the potential to eliminate the liquidity required to operate the Fund in an efficient manner. On January 18, 2016, the Fund re-opened to redemptions and was halted again after cumulative redemptions for fiscal 2016 reached approximately 20% of the NAV as at the last day of fiscal 2015, as contemplated in the Fund's prospectus disclosure.

On October 24, 2016 the Fund was re-opened and subsequently closed to reflect the objective of the Fund meeting the annual redemption requirement of approximately 20% of the NAV as at the last day of fiscal 2016, as contemplated in the Fund's prospectus disclosure.

AUGUST 31, 2017

[In \$ thousands of Canadian dollars, except per share amounts and number of shares]

## 6. REDEEMABLE SHARES (Cont'd)

On August 25, 2017, the Fund announced that it expects to re-open to redemptions prior to December 31, 2017 at which time the Fund anticipates redeeming up to 20% of the NAV as at the last day of fiscal 2017. The intent is to close the Fund again if and when the Fund reaches the 20% redemption limit. The re-opening of the Fund will allow the Fund to honour redemptions up to 20% of the NAV of the Fund in the 2017/2018 fiscal year as contemplated in the Fund's prospectus disclosure. The Fund anticipates that the next redemption opportunity will not occur until after September 1, 2018.

For Class A Shares, Series I, a redemption fee is charged in the amount of up to 6% of the redemption price calculated as 0.75% of the redemption amount times the number of years or part years remaining until the eighth anniversary date of issue.

For Class A Shares, Series II, the redemption fee charged is dependent upon the origination of the Shares. For Class A Shares, Series II issued as transaction shares on account of former holders of the Merged Funds Series A or Series B, a redemption fee of up to 6% of the offering price is calculated as 0.75% of the redemption amount times the number of years or part years remaining until the eighth anniversary date of issue. For Class A Shares, Series II issued as transaction shares on account of former holders of the Merging Funds Series C shares, a redemption fee of up to 10% of the offering price calculated as 1.25% of the redemption amount times the number of years or part years remaining until the eighth anniversary date of issue.

### Class B Shares

There are 199 Class B shares issued and outstanding to the Co-Sponsors (100 to the Canadian Police Association and 99 to the Association of Canadian Financial Officers). No Class B shares have been issued or redeemed in the years ended August 31, 2017 or 2016.

## 7. NON-MONETARY TRANSACTIONS

Included in interest income from the venture portfolio is Nil of interest (2016-\$6,790) earned as a result of various debt refinancing activities. The Fund did not receive cash but recorded the interest income at fair value in accordance with the provisions of the debt instruments that were converted within the venture portfolio.

During the year, the Fund exchanged securities with a cost base of NIL (2016-\$32,551) for new debt or equity instruments with a fair value of NIL (2016-\$39,432).

## 8. FEES AND EXPENSES

The Fund has entered into various agreements for the provision of management services including: fund management, sponsor, administration (including transfer agency), dealer and custodial services. Under the terms of certain of these agreements, the Fund may be required to pay fees based on the net asset value of the Fund.

The Fund has entered into agreements for the following annual fee rates, which, unless otherwise stated, are paid monthly based on the average net asset value of the Fund:

|                     |   |
|---------------------|---|
| Fund management     | 1.35%   |
| Co-Sponsor fees     | 0.16% (0.11% to the ACFO and 0.05% to the CPA)  |
| Fund administration | 0.45%   |
| Dealer service fees | 0.50% on Class A Shares, Series I and 0.50% on certain Class A Shares, Series II after the eighth year of issue |

## NOTES TO FINANCIAL STATEMENTS

AUGUST 31, 2017

[In \$ thousands of Canadian dollars, except per share amounts and number of shares]

### 8. FEES AND EXPENSES (Cont'd)

Covington is entitled to a conditional incentive participation amount (the "IPA") based on the performance of the Fund. Before any payment, the Fund must satisfy the following criteria: (i) The Fund must earn sufficient income to generate a rate of return on the eligible investment portfolio greater than the average of the 5-year GIC rate of the five major banks plus 2% on an annualized basis; (ii) for a particular investment, the Fund must earn a cumulative investment return at an average annual rate in excess of 12% since investment; and (iii) the Fund must fully recoup an amount equal to all principal invested in the particular investment (including for assets from the Merged Funds, the amounts invested by the predecessor Merged Fund).

If these performance criteria as outlined in the Fund's offering documents and/or annual information form have been met, the Fund records Conditional IPA. Conditional IPA represents a provisional estimate of what would be payable to the manager if the entire venture portfolio of the Series were disposed of at fair value as at the reporting date, whereas IPA payable is based on actual realized transactions. Conditional IPA was formerly referred to as "Contingent IPA" prior to the adoption of IFRS by the Fund.

Subject to all of the above, the Fund pays an IPA of 15% of all income earned from the particular investment acquired from the Merged Funds since the date the investment was acquired by the Fund. For the purposes of future IPA payments, the Merged Funds' portfolio assets will be tracked with a hurdle that will have a cost equal to the fair value on September 2, 2011. With respect to the pre-merger Fund assets and any new investments (other than follow-on investments), the Fund will pay a 20% IPA if both the portfolio and specific investments achieve the criteria (i), (ii), and (iii) above.

The movement of Conditional IPA accruals or IPA payable is summarized below:

| Expensed<br>year ended<br>August 31, 2017<br>\$ | Expensed<br>year ended<br>August 31, 2016<br>\$ | Accrued as at<br>August 31, 2017<br>\$ | Accrued as at<br>August 31, 2016<br>\$ | Paid<br>year ended<br>August 31, 2017<br>\$ | Paid<br>year ended<br>August 31, 2016<br>\$ |
|---|---|--|--|---|---|
| 460   | 1,612   | 670                                    | 4,024                                  | 3,814                                       | 1,528                                       |

Directors of the Fund are entitled to receive an annual fee of \$50 each (which has been reduced to \$35 per annum after June 1, 2017) plus reimbursement of expenses incurred to attend meetings.

Members of the Funds' Independent Review Committee ("IRC") also serve another LSIF managed by Covington. The IRC members each receive total remuneration across all Funds of \$12 per year (reduced from \$15 effective November 1, 2016), plus a per meeting fee of \$2 for the Chairperson and \$1.5 per meeting for each of the other two members. The annual fee is allocated across all of the Funds served by the IRC whereas per meeting fees are borne by the particular fund for which the meeting is called, if any.

During the course of the Fund's investment activities, the Fund may pay commissions and other transaction costs to dealers in connection with purchases and sales of investments. During the year, the Fund paid commissions of Nil (2016 - \$117).

#### VenGrowth contract amount

Upon completion of the merger transaction on September 2, 2011, the Fund acquired the assets of the VenGrowth Funds including: venture assets, vendor rights, reserves, and all other assets of such funds. Included in the acquisition were commitments to the VenGrowth Managers for the elimination of existing management agreements in connection with the disposal of their business. Payment of these amounts were approved by shareholders of both the Fund and the Merged Funds pursuant to the transaction and were structured such that no incremental costs were borne by the shareholders beyond those that existed prior to the merger.

The structure results in the following payments by the Fund to the VenGrowth Managers: (i) 1.4% per annum of the net asset value of the Fund paid on a monthly basis; (2) capital maintenance payments of 1.15% per annum paid monthly of the issue cost on all Class A transaction shares issued for the Merged Funds (excluding NGBE) Series A,B,E and F issued after December 31, 2003 and 1.65% per annum paid monthly of the issue cost on Class A transaction shares issued for Merging Funds (excluding NGBE) Series C shares. These are for finance and administration costs related to sales commission financing and terminate after the eighth anniversary of that date of original share issuance and (3) 50% of any IPA paid during the year.

AUGUST 31, 2017

[In \$ thousands of Canadian dollars, except per share amounts and number of shares]

### 9. RELATED PARTY TRANSACTIONS

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The Fund receives investment advisory services provided by the Manager. These services are in the normal course of operations and the remunerations are recorded at the amount of the considerations agreed to by the parties, as described in Note 8. Management fees, incentive participation amount and sponsor's fees are reported in the Statements of Comprehensive Income. Amounts due to/from the Manager and contingent incentive participation amount payable to the Manager at period-end, if any, are reported in the Statements of Financial Position. Included in accrued expenses as at August 31, 2017 is \$1,698 (2016 - \$161) due to the Manager for accrued management fees. Also see Note 5 for additional related party transactions.

### 10. LOAN PAYABLE

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On October 24, 2016 the Fund entered into an agreement for third party financing with Espresso Capital ("Espresso") to provide up to \$3,750. The Fund drew and repaid \$ 3,000 during the year. The Fund paid interest and fees of \$238 to Espresso. As part of securing the debt facility, the Manager was required to advance \$1.5 million by way of debt into the Fund and was also repaid during the year with no interest charged. These debt facilities were utilized by the Fund to meet the 20% annual redemption requirement. No debt facility was utilized in fiscal 2016.

### 11. INCOME TAXES

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Under the Act, no income taxes are payable by the Fund on dividends received from Canadian corporations, and income taxes payable on capital gains will be fully refundable on a formula basis when shares of the Fund are redeemed or capital gains dividends are paid or deemed to be paid by the Fund to its shareholders. A portion of the income taxes payable on dividend income earned by the Fund is also refundable on payment or on a deemed payment of dividends to the shareholders.

Both the Act and the Ontario Act set minimum levels of venture investments for the Fund. If the minimum level of qualifying venture investments is not met as at the calendar year end, the Fund will be subject to defined taxes and penalties. As at December 31, 2016, the Fund is in compliance with both requirements set out in the Tax Act and the Ontario Act.

The Fund has capital losses of \$23,022 and non-capital losses of \$69,238 available to offset future taxable capital gains and income respectively. The benefit, if any, of these losses have not been recognized in these financial statements. If not utilized, the non-capital losses will expire as follows: 2037 - \$7,131; 2036 - \$593; 2035 - \$9,617; 2034 - \$21,151; 2033 - \$9,065; 2032 - \$6,874; 2031 - \$1,846; 2030 - Nil; 2029 - Nil; 2028 - \$3,768; 2027 - \$5,268; and 2026 - \$3,925. Capital losses can be carried forward indefinitely.

The tax amounts reflected in these financial statements are based on management's best estimate of the amounts that will ultimately be assessed. This determination is based on numerous factors such as the pace at which the Fund makes qualifying venture investments, the amount of share capital raised and redeemed, and the net income and undistributed net realized gains (losses) on sale of investments by the Fund. Should actual events not agree with the estimates made by management of the Fund, material adjustments to the tax amounts may be required.

## NOTES TO FINANCIAL STATEMENTS

AUGUST 31, 2017

[In \$ thousands of Canadian dollars, except per share amounts and number of shares]

### 12. FINANCIAL INSTRUMENTS

#### Fair value hierarchy

The following describes the three-level hierarchy for fair value measurements based on transparency of inputs to the valuation of an asset or liability as at the measurement dates. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable market inputs (Level 3). The three levels of the fair value hierarchy are:

##### *Level 1 – Quoted Prices in an Active Market*

Unadjusted quoted prices in active markets for identical assets or liabilities. This level of the hierarchy includes listed equity securities on major exchanges, highly liquid temporary deposits with Canadian Banks, as well as term deposits, bank deposit notes and corporate bonds. The fair value of instruments that are quoted in active markets are determined using the quoted prices where they represent those at which regularly and recently occurring transactions take place.

##### *Level 2 – Valuation Techniques with Observable Parameters*

Inputs other than quoted prices included in Level 1 that are observable for the asset and liability either directly (ie. as prices) or indirectly (ie. derived from prices). Since the inputs may be observable inputs but the application of a valuation model is used, these financial instruments are considered Level 2.

##### *Level 3 – Valuation Techniques with Significant Unobservable Parameters*

Inputs that are not based on observable market inputs Level 3 instruments include equities, debentures, term loans and promissory notes issued by privately-held companies. As observable prices are not available for these securities, the Fund may use a variety of valuation techniques to derive the fair value.

If different levels of inputs are used to measure a financial instrument's fair value, the classification within the hierarchy is based on the lowest level input that is significant to the fair value measurement. These amendments have been made to address the need for increased consistency and comparability of fair value measurements, and to expand the disclosure surrounding fair value measurements and do not have any impact on the net assets of the Fund.

#### Financial Instruments Carried at Fair Value

The following table classifies the carrying value of the Fund's financial instruments held at fair value across the fair value hierarchy as at August 31, 2017 with comparatives as at August 31, 2016:

|                               | Financial instruments at fair value |          |                |                |
|-------------------------------|-------------------------------------|----------|----------------|----------------|
|                               | Level 1                             | Level 2  | Level 3        | Total          |
| August 31, 2017               | \$                                  | \$       | \$             | \$             |
| Marketable securities         | -                                   | -        | -              | -              |
| Venture investments           | 8                                   | -        | 91,434         | 91,442         |
| <b>Total financial assets</b> | <b>8</b>                            | <b>-</b> | <b>91,434</b>  | <b>91,442</b>  |
| <b>August 31, 2016</b>        |                                     |          |                |                |
| Marketable securities         | -                                   | -        | -              | -              |
| Venture investments           | 8                                   | -        | 119,428        | 119,436        |
| <b>Total financial assets</b> | <b>8</b>                            | <b>-</b> | <b>119,428</b> | <b>119,436</b> |

During the year ended August 31, 2017 there were no transfers between any of the three levels of the valuation hierarchy. (2016 - \$13,021 transfer out of level 3 into level 1).

AUGUST 31, 2017

[In \$ thousands of Canadian dollars, except per share amounts and number of shares]

12. FINANCIAL INSTRUMENTS (Cont'd)

The following is a reconciliation of Level 3 fair value measurements:

|  | August 31, 2017<br>\$ | August 31, 2016<br>\$ |
|--|-----------------------|-----------------------|
| Level 3 balance, beginning of year   | 119,428               | 182,648               |
| Purchase of investments  | 4,281                 | 59,881                |
| Sale/repayment of investments  | (17,979)              | (62,587)              |
| Net transfers into and/or out of Level 3   | -                     | (13,021)              |
| Change in unrealized losses  | (18,958)              | (25,679)              |
| Net realized gains/(losses)  | 4,662                 | (21,814)              |
| <b>Level 3 balance, end of year</b>  | <b>91,434</b>         | <b>119,428</b>        |
| <b>Total change in unrealized gains and losses during the year included in the statements of Comprehensive Income for assets held at end of year</b> | <b>(18,958)</b>       | <b>(16,460)</b>       |

Risk management

The Fund's activities expose it to a variety of financial risks: valuation risk, market risk (which includes currency risk, interest rate risk and other price risk), liquidity risk and credit risk, as described below. The Fund's overall risk management programs seek to minimize potential adverse effects on the Fund's financial performance through a regular program of monitoring the Fund's investment positions and updating the valuation of the private company portfolios. The value of investments within a portfolio can fluctuate daily as a result of changing economic and market conditions, prevailing interest rates and company specific news relating to portfolio investments.

The Fund has managed this risk through its Valuation Committee that reviews quarterly reports from the Manager on the investment portfolio as a whole, and on determination of fair value for the venture investments including a discussion of significant events affecting the valuation of such investments. This Committee is independent from the Manager and is responsible for considering the appropriateness of the valuation policies adopted by the Fund and the Manager.

(a) Valuation and other market risk

There is a risk of loss of capital associated with all venture investments of the Fund. Valuation risk is the risk that the estimated fair values of investments for which no quoted market value exists as determined by the Manager may differ from values that would have been used had a ready market existed for these investments. Other market risk is the risk that the value of the venture investments will fluctuate as a result of changes in market prices.

Among the assets held for trading by the Fund are venture investments for which no quoted market values exist.

These investments are in privately held companies whereby fair values are estimated by the Manager using valuation techniques as described in Note 3.

## NOTES TO FINANCIAL STATEMENTS

AUGUST 31, 2017

[In \$ thousands of Canadian dollars, except per share amounts and number of shares]

### 12. FINANCIAL INSTRUMENTS (Cont'd)

Included in the Statements of Comprehensive Income for the Fund are changes in unrealized gains or losses on venture investments for which the fair values have been estimated based on assumptions that may not be supported by observable market prices. The potential effect of changing the assumptions to reasonably possible alternative assumptions on the fair value of the venture investments could result in a decrease or increase in net assets as at August 31, 2017 and 2016 as follows:

| August 31, 2017                                |                                 | August 31, 2016                                |                                 |
|--|---------------------------------|--|---------------------------------|
| Fair value of privately held investments<br>\$ | Decrease/Increase in net assets | Fair value of privately held investments<br>\$ | Decrease/Increase in net assets |
| 91,434   | -7.87% to +3.54%                | 119,428  | -6.44% to +4.76%                |

The tables below summarize the significant unobservable inputs used in the fair value measurement of Level 3 financial instruments.

For the purposes of these tables, venture investments are broken down as debt and equity. With respect to equity investments, those investments that are expected to require further significant investment to reach cash flow break-even are classified as early stage, those which may require strategic follow-on financing to grow are classified as expansion stage, other equity investments are classified as later stage.

#### As at August 31, 2017

| Description            | Fair value<br>\$ | Valuation technique          | Unobservable inputs       | Reasonable possible shift in value | Change in valuation +/-<br>\$ |
|------------------------|------------------|------------------------------|---------------------------|------------------------------------|-------------------------------|
| Debt                   | 45,782           | Estimated realizable value   | Probability of collection | -14.89% to +5.35%                  | -6,816 to +2,450              |
| Early stage equity     | 21,898           | Last equity round            | Discount rate             | -0.80% to +0.80%                   | -174 to +174                  |
| Expansion stage equity | 13,449           | Comparable trading multiples | Revenue multiple          | -1.85% to +1.85%                   | -249 to +249                  |
| Later stage equity     | 5,732            | Comparable trading multiples | EBITDA multiple           | -0.00% to +0.00%                   | -                             |
| Underlying funds       | 4,573            | Net asset value per share    | Net asset value per share | -0.51% to +8.70%                   | -23 to +398                   |

#### As at August 31, 2016

| Description            | Fair value<br>\$ | Valuation technique          | Unobservable inputs       | Reasonable possible shift in value | Change in valuation +/-<br>\$ |
|------------------------|------------------|------------------------------|---------------------------|------------------------------------|-------------------------------|
| Debt                   | 56,964           | Estimated realizable value   | Probability of collection | -13.95% to +6.12%                  | -7,945 to +3,485              |
| Early stage equity     | 22,716           | Last equity round            | Discount rate             | -0.00% to +0.00%                   | -                             |
| Expansion stage equity | 21,479           | Comparable trading multiples | Revenue multiple          | -0.00% to +4.25%                   | 0 to +912                     |
| Later stage equity     | 10,785           | Comparable trading multiples | EBITDA multiple           | -4.43% to +8.96%                   | -478 to +966                  |
| Underlying funds       | 7,484            | Net asset value per share    | Net asset value per share | -8.67% to +17.92%                  | -649 to +1,341                |

The process of valuing investments for which no published market exists is inevitably based on inherent uncertainties and the resulting values may differ from values that would have been used had a ready market existed for the investments and may not reflect the prices at which the Fund's investments may actually be sold.

AUGUST 31, 2017

[In \$ thousands of Canadian dollars, except per share amounts and number of shares]

**12. FINANCIAL INSTRUMENTS (Cont'd)**

**(b) Foreign currency risk**

Changes in currency rates will impact the carrying value of financial instruments denominated in currencies other than the Canadian dollar. Although the Manager has flexibility to manage the foreign currency risk by hedging its currency exposure, the Manager did not engage in currency hedging during the period due to the low volume of foreign currency transactions involved. Increases and decreases in the exchange rate between the Canadian currency and the foreign currency may increase or decrease the value of the foreign currency denominated investments within the Fund.

The Fund had exposure to US dollars ("USD") as at August 31, 2017 and 2016 as follows:

| August 31, 2017                              |   | August 31, 2016                              |   |
|--|---|--|---|
| USD Financial instruments denominated in CAD | Impact of a +/-2% change in Canadian dollar relative to USD on the Net Assets of the Fund | USD Financial instruments denominated in CAD | Impact of a +/-2% change in Canadian dollar relative to USD on the Net Assets of the Fund |
| 10,746                                       | -215 to +215  | 16,446                                       | -329 to +329  |

In practice, the actual trading results may differ from this sensitivity analysis and the difference could be material.

**(c) Interest rate risk**

The value of debt securities will be affected by changes in applicable interest rates. If interest rates fall, the fair value of existing debt securities may increase due to the increase in yield. On the other hand, if interest rates rise, the yield of existing debt securities will decrease which will lead to a decrease in fair value. The magnitude of the change will generally be greater for long-term debt securities than short-term debt securities.

Interest rate risk also applies to convertible securities. The fair value of these securities varies inversely with interest rates, similar to other debt securities. However, since they may be converted into common shares, convertible securities are generally less affected by interest rate fluctuations than other debt securities. Below is a breakdown of debt instruments by maturity:

| Debt instruments by maturity date | Less than 1 year<br>\$ | 1-3 years<br>\$ | 3-5 years<br>\$ | Greater than 5 years<br>\$ |
|-----------------------------------|------------------------|-----------------|-----------------|----------------------------|
| As at August 31, 2017             | 76,484                 | 4,750           | -               | -                          |
| As at August 31, 2016             | 74,604                 | 7,501           | -               | -                          |

**(d) Other price risk**

Other price risk is the risk that the fair value or future cash flows of the investments will fluctuate because of changes in market prices. In addition to venture investments for which no quoted market values exist, the Fund also holds investments which are publicly traded on a recognized stock exchange.

There is market price risk associated with the Fund since as at August 31, 2017 - \$8 or 0.0% (August 31, 2016 - \$8 or 0.0%) of net assets attributable to holders of redeemable shares is invested in publicly-traded securities.

**(e) Liquidity risk**

Liquidity risk is defined as the risk that a fund may not be able to settle or meet its obligations on time or at a reasonable price. Fair value of investments with low liquidity may have significant variances or impairments if a Fund is required to enter into a forced liquidation scenario.

AUGUST 31, 2017

[In \$ thousands of Canadian dollars, except per share amounts and number of shares]

### 12. FINANCIAL INSTRUMENTS (Cont'd)

#### (e) Liquidity risk (Cont'd)

The Fund is not required to redeem Class A Shares, in any financial year having an aggregate redemption price exceeding 20% of the Net Asset Value of the Fund as at the last day of the preceding fiscal year. Many of the Fund's investments are held in non-liquid securities. As such, if all shareholders were to redeem their shares at the same time, the Fund would need to liquidate these investments in order to meet the redemption requests.

The Fund was initially launched in 1999. The majority of the Fund's units are currently eligible for redemption such that if all shareholders eligible for redemption were to do so, the Fund would not have sufficient liquid resources to honour all redemptions.

In reality the Fund cannot immediately liquidate 100% of its securities practically due to the lack of a ready market for private companies and more notably, without incurring discounts to fair values which would in turn, negatively impact the NAV of the Fund.

#### (f) Credit risk

Credit risk is the risk that a debt security issuer or counterparty cannot meet its financial obligations, such as making interest payments or principal repayments. Issuers that have suffered adverse changes in financial conditions may receive a low credit rating reflecting a high credit risk. A change in the credit rating of the debt security can affect its liquidity and may result in an impairment of its fair value. The Manager manages credit risk by investing the bond portfolio of the Fund in high quality investment grade debt obligations with a minimum rating of "A" at the time of investment. Currently, the Fund does not hold such debt instruments in its portfolio.

The Fund holds a portion of its investment portfolio in private debt instruments which can be considered high risk debt instruments. As at August 31, 2017, the Fund had \$81,234 (August 31, 2016 - \$82,105) invested in these assets. These instruments are not rated by any of the market bond rating services and are also subject to valuation risk as described in part (a) above.

The Fund has provided guarantees of \$1,511 to investee companies (August 31, 2016 - \$7,340). Should the guarantees be drawn, the amounts would be recorded as follow-on investments (see Note 5).

### 13. ACCOUNTING STANDARDS ISSUED BUT NOT YET ADOPTED

#### IFRS 9, Financial Instruments ("IFRS")

The IASB issued the final version of IFRS 9 Financial Instruments that replaces IAS 39 Financial Instruments: Recognition and Measurement and all previous versions of IFRS 9. IFRS 9 brings together all three aspects of the accounting for financial instruments project: classification and measurement, impairment and hedge accounting. IFRS 9 is effective for annual periods beginning on or after January 1, 2018, with early application permitted. Except for hedge accounting, retrospective application is required, but the provision of comparative information is not mandatory. For hedge accounting, the requirements are generally applied prospectively, with some limited exceptions.

The Fund plans to adopt the new standard on the required effective date. During 2017, the Fund has performed a high-level impact assessment of all three aspects of IFRS 9. This assessment is based on currently available information and may be subject to changes arising from further detailed analyses or additional reasonable and supportable information being made available to the Fund in the future. Overall, the standard is not expected to have a material impact on the measurement basis of the financial assets held by the Fund since majority of the financial assets are measured at fair value through profit or loss. The Fund expects to continue measuring at fair value all financial assets currently held at fair value. Debt securities are expected to be measured at FVPL under IFRS 9 as the Fund does not expect to hold the assets to collect contractual cash flows. Therefore, no impact on the Net Assets and the results of the Fund is expected from the adoption of IFRS 9.

### 14. SUBSEQUENT EVENT

On November 3, 2017, investee company Axela Inc. was purchased by Angle PLC. The proceeds the Fund is expected to receive for its interest in Axela Inc. approximate the August 31, 2017 carrying value of this investment.

**Fund Symbols**

**Covington Fund II Inc.**

CIG912 - Closed

CIG 961 - Closed

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