Covington Capital Corporation

2016 | Annual Report

Covington Fund II Inc.

For The Year Ended August 31, 2016

TABLE OF CONTENTS

FINANCIAL STATEMENTS

NOTES TO FINANCIAL STATEMENTS

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 judgments. 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 also 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 Clark

Scott D. Clark
President & CEO,
Covington Capital Corporation

Stephen G. Campbell

Stephen Campbell
Chief Financial Officer,
Covington Capital Corporation

Toronto, Canada
November 14, 2016

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, 2016 and August 31, 2015, 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, 2016 and 2015, 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, 2016 and August 31, 2015, and its financial performance and cash flows for the years then ended August 31, 2016 and August 31, 2015 in accordance with International Financial Reporting Standards.

Ernst & Young LLP

Chartered Professional Accountants
Licensed Public Accountants

Toronto, Canada
November 14, 2016

STATEMENTS OF FINANCIAL POSITION

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

As at		**August 31, 2016** **$**		August 31, 2015 $
ASSETS AND LIABILITIES				
Assets				
Cash		**15,428**		17,951
Restricted cash [Note 5]		**3,090**		-
Marketable securities, at fair value		**-**		3,528
Venture investments, at fair value		**119,436**		193,450
Receivable for investments sold		**8,300**		6,761
Interest and dividend receivable		**-**		28
Other assets		**57**		-
		146,311		221,718
Liabilities				
Accounts payable and accrued liabilities		**1,457**		3,073
Conditional incentive participation amount payable [Note 8]		**4,024**		3,940
Redemptions payable		**-**		117
		5,481		7,130
Net assets attributable to holders of redeemable shares		**140,830**		214,588
Net assets attributable to holders of redeemable shares per Series				
Class A, Series I	**$**	**84,636**	$	127,748
Class A, Series II	**$**	**56,194**	$	86,840
Redeemable Class A Shares outstanding [Note 6]				
Class A, Series I		**12,385,692**		15,655,888
Class A, Series II		**8,645,176**		11,166,508
Net assets attributable to holders of redeemable shares per share [Note 6]				
Class A, Series I	**$**	**6.83**	$	8.16
Class A, Series II	**$**	**6.50**	$	7.78

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]

For the years ended August 31,	2016 $	2015 $
INCOME		
Net gain/(loss) on financial instruments:		
Interest for distribution purposes	**7,340**	1,444
Dividends	**16,948**	665
Realized gain/(loss) on sale of investments	**(32,575)**	24,282
Realized gain/(loss) on foreign exchange	**(17)**	2,537
Recovery of escrow receivable	**2,755**	-
Change in unrealized depreciation of marketable securities	**(27)**	(183)
Change in unrealized depreciation of venture investments	**(16,460)**	(38,175)
Other income/(loss)	**5**	(4)
	(22,031)	(9,434)
EXPENSES		
VenGrowth contract amount [Note 8]	**2,260**	3,293
Management fees [Note 8]	**2,181**	3,222
Conditional incentive participation amount [Note 8]	**1,612**	1,421
Service fees [Note 8]	**789**	1,156
Fund administrator fees [Note 8]	**732**	1,074
Harmonized Sales Taxes	**628**	802
Capital maintenance payment [Note 8]	**149**	477
Directors' fees	**361**	350
Shareholder communications	**342**	278
Sponsor fees [Note 8]	**259**	382
Audit fees	**246**	337
Custody fees	**44**	60
Legal fees	**26**	18
Independent Review Committee	**25**	27
Other	**(897)**	221
	8,757	13,118
Increase (decrease) in net assets attributable to holders of redeemable shares	**(30,788)**	(22,552)
Decrease in net assets attributable to holders of redeemable shares per Series		
Class A, Series I	**(18,506)**	(13,427)
Class A, Series II	**(12,282)**	(9,125)
Decrease in net assets attributable to holders of redeemable shares per share (based on weighted average number of shares outstanding)		
Class A, Series I	**$ (1.40)**	$ (0.84)
Class A, Series II	**$ (1.33)**	$ (0.77)
Weighted average number of shares outstanding		
Class A, Series I	**13,252,064**	16,078,242
Class A, Series II	**9,203,124**	11,808,348

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,	2016 $	2015 $
[1] **Breakdown of realized gain/(loss) on sale of investments:**		
Marketable securities		
Bonds, at cost, beginning of year	-	498
Accretion of discount	-	5
Bonds purchased during the year	-	-
	-	503
Bonds, at cost, end of year	-	-
Cost of bonds sold	-	503
Proceeds from sale of bonds	-	507
Realized gain on sale of bonds	-	4
Equities, at cost, beginning of year	**3,501**	11,552
Equities purchased during the year	-	-
	3,501	11,552
Equities, at cost, end of year	-	3,501
Cost of equities sold	**3,501**	8,051
Proceeds from sale of equities	**3,397**	8,407
Realized gain/(loss) on sale of equities	**(104)**	356
Realized gain/(loss) on sale of marketable securities	**(104)**	360
Venture investments		
Venture investments, at cost, beginning of year	**222,966**	233,855
Venture investments purchased during the year	**59,881**	42,811
Venture investments repaid during the year	**(19,122)**	(1,858)
	263,725	274,808
Venture investments, at cost, end of year	**165,412**	222,966
Cost of venture investments sold	**98,313**	51,842
Proceeds from sale of venture investments	**65,842**	75,764
Realized gain/(loss) on sale of venture investments	**(32,471)**	23,922
Realized gain/(loss) on sale of investments	**(32,575)**	24,282

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,	2016 $	2015 $
Net assets attributable to holders of redeemable shares, beginning of year	**214,588**	260,589
Decrease in net assets attributable to holders of redeemable shares	**(30,788)**	(22,552)
REDEEMABLE SHARE TRANSACTIONS		
Class A Shares, Series I		
Amounts paid for Class A Shares, Series I redeemed	**(24,606)**	(10,241)
Class A Shares, Series II		
Amounts paid for Class A Shares, Series II redeemed	**(18,364)**	(13,208)
Net assets attributable to holders of redeemable shares, end of year	**140,830**	214,588

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

STATEMENTS OF CASH FLOWS

[in $ thousands of Canadian dollars]

For the years ended August 31,	2016 $	2015 $
Operating activities		
Decrease in net assets attributable to holders of redeemable shares	**(30,788)**	(22,552)
Items not affecting cash:		
Realized (gain)/loss on sale of investments	**32,575**	(24,282)
Accretion of bond discount	**-**	(5)
Change in unrealized depreciation of investments	**16,487**	38,358
Fee income from venture investments [Note 5]	**(6,790)**	(1,088)
Purchase of venture investments	**(20,539)**	(14,081)
Net proceeds/(purchase) of short term investments	**-**	999
Repayment of venture debt	**19,122**	1,858
Proceeds from sale of bonds	**-**	507
Proceeds from sale of equities	**3,397**	8,407
Proceeds from sale of venture investments	**33,291**	48,122
Increase in restricted cash [Note 5]	**(3,090)**	-
Change in non-cash working capital:		
Change in other assets and liabilities	**(3,101)**	(4,441)
	40,564	31,802
Financing activities		
Amounts paid for Class A Shares redeemed, Series I and II	**(43,087)**	(23,334)
	(43,087)	(23,334)
Increase/(decrease) in cash during the year	**(2,523)**	8,468
Cash, beginning of year	**17,951**	9,483
Cash, end of year	**15,428**	17,951
Non-monetary transactions [Note 7]		
Securities received from debt financing and share exchange	**39,342**	28,730
Proceeds from share exchange	**32,551**	27,642
Supplementary information:		
Dividends received*	**16,948**	665
Interest received*	**7,340**	355

* *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, 2016

Venture investments

Investee companies	Number of shares (or par value $)	Debt at cost $	Equity at cost $	Total $
2203077 Ontario Limited, Promissory Note, 5%, due May 31, 2017	$36,158	25	-	25
2210961 Ontario Limited, Loan, 6%, due April 19, 2018	$5,633,057	2,751	-	2,751
2210961 Ontario Limited, Demand Loan, 6%	$125,000	125	-	125
2210961 Ontario Limited, Common	50,000	-	-	-
Active Exhaust Corporation, Class B Common	502,768	-	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%	$2,500,000	2,511	-	2,511
Axela Inc., Demand Convertible Debenture, 12%	$11,100,000	11,100	-	11,100
Axela Inc., 12% Notes Payable	325,000	325	-	325
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%	$150,000	113	-	113
bitHeads Inc., Class A Preferred	9,300,000	-	1,500	1,500
bitHeads Inc., Class B Preferred	7,719,528	-	842	842
Black Bull Resources Inc., Common†	1,550,000	-	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
Epocal Inc., Rights*	2,827,341	-	-	-
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	-	1,554	1,554
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
Masstech Innovations Inc., Demand Promissory Note, 10%	$1,146,473	1,146	-	1,146
Masstech Innovations Inc., Common	1,000,000	-	-	-
Mist Mobility Integrated Systems Technology Inc., Demand Promissory Note, 12%	$14,000,000	12,950	-	12,950
Mist Mobility Integrated Systems Technology Inc., Demand Debenture, 15%	$750,000	750	-	750

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 (or par value $)	Debt at cost $	Equity at cost $	Total $
Mist Mobility Integrated Systems Technology Inc., 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
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	-	4,414	4,414
Nakina Systems Inc., Warrants*	13,705,577	-	444	444
Nakina Systems Inc., Class C Warrants, expiry June 20, 2017*	225,000	-	-	-
Nakina Systems Inc., Class C Warrants, expiry October 17, 2019*	77,737,500	-	-	-
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%	$1,715,000	1,715	-	1,715
PowerBand Global Inc., Demand Debenture, 24%	$2,063,376	2,063	-	2,063
Roll-Tite Corporation, Demand Loan, 10%	$1,000,000	1,000	-	1,000
Roll-Tite Corporation, Demand Loan, 20%	$227,512	90	-	90
Roll-Tite Corporation, Common	85,000	-	-	-
Signal Hill Equity Partners II, LP	2,738,090	-	1,474	1,474
Simex Inc., Series A Preferred	58,871	-	-	-
Spartan Bioscience Inc., Common	2,010,000	-	231	231
Trilliant Inc., Common	2,261,314	-	-	-
VG Mezzanine I Limited Partnership	13,590	-	2,021	2,021
WireIE Holdings International Inc., Secured Convertible Debenture, 10%, due March 13, 2018	$4,750,000	4,750	-	4,750
WireIE Holdings International Inc., Demand Promissory Note, 12%	$23,075,000	23,075	-	23,075
WireIE Holdings International Inc., Common	28,244,887	-	8,062	8,062
WireIE Holdings International Inc., Preferred	1	-	-	-
Total venture investments, at cost		82,105	83,307	**165,412**
Unrealized appreciation/(depreciation) of venture investments				(45,976)
Venture investments, at fair value				**119,436**
Total investments, at fair value				**119,436**
Other assets, net of liabilities				21,394
Net assets attributable to holders of redeemable shares				**140,830**

** 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]

As at August 31, 2016	Number of companies	Cost of investments $	% Total venture investments at cost %	Fair value of investments $	% Total venture investments at fair value %
Stage of Development					
Start-Up/Early	5	76,791	46.4	54,654	45.8
Expansion	17	75,776	45.8	55,565	46.5
Later	6	12,845	7.8	9,217	7.7
	28	**165,412**	**100.0**	**119,436**	**100.0**
Industry Class					
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
	28	**165,412**	**100.0**	**119,436**	**100.0**
As at August 31, 2015					
Stage of Development					
Start-Up/Early	5	42,894	19.2	34,676	18.0
Expansion	21	140,994	63.2	121,936	63.0
Later	8	39,078	17.6	36,838	19.0
	34	**222,966**	**100.0**	**193,450**	**100.0**
Industry Class					
Biotechnology/Health Sciences	7	72,644	32.6	51,005	26.4
Financial Services	4	9,652	4.3	9,470	4.9
Technology	15	94,186	42.3	84,354	43.6
Manufacturing/Distribution	8	46,484	20.8	48,621	25.1
	34	**222,966**	**100.0**	**193,450**	**100.0**

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

AUGUST 31, 2016

[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 87 Front Street East, Suite 400, Toronto, Ontario M5E 1B8. These financial statements were authorized for issue by the Fund's Board of Directors on November 14, 2016.

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

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

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 are designated as financial assets 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.

[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 techniques 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: a financial asset or financial liability is designed 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.

[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 2016 fiscal year the Company recognized a recovery of $2,755 (2015 - $nil).

AUGUST 31, 2016

[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 revenues 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:

		Proportion of ownership and voting rights	
Name	**Relationship**	**August 31, 2016**	**August 31, 2015**
2210961 Ontario Ltd.	Subsidiary	50%	50%
Axela Inc.	Subsidiary	79%	78%
Bitheads Inc.	Associate	25%	24%
Clek Inc.	Associate	35%	36%
Fidelity PAC Metals Ltd.	Subsidiary	50%	50%
Interface Biologics Inc.	Associate	45%	45%
Ivey CSBIF I Inc.	Subsidiary	53%	53%
Ivey CSBIF II Inc.	Subsidiary	53%	53%
Masstech Innovations Inc.	Subsidiary	89%	100%
Mist Mobility Integrated Systems Technology Inc.	Associate	30%	30%
Nakina Systems Inc.	Associate	40%	36%
OTYC Holdings Inc.	Associate	21%	21%
Powerband Global Inc.	Subsidiary	51%	27%
Roll-Tite Inc.	Subsidiary	85%	85%
VG Mezzanine I Limited Partnership	Associate	36%	36%
WireIE Holdings International Inc.	Subsidiary	70%	69%

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

AUGUST 31, 2016

[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

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. If Axela does not refinance the credit facility by January 31, 2017, these funds will be drawn from the restricted cash account and the amount would be recorded as a follow-on investment in Axela.

Additionally the Fund has provided a joint and several guarantee totalling $4,248 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:

Company	Financings completed
Axela Inc.	$625 (2015 - $2,100) in a 12% convertible debenture due March, 2016
WireIE International Inc	$19,325 (2015 - $3,750) in 12% demand promissory notes
Masstech Innovations Inc.	$NIL (2015 - $1,147) in 10% demand promissory notes
Powerband Global Inc.	$290 (2015 - $1,228) 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, 2015, 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.

AUGUST 31, 2016

[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, 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

For the year ended August 31, 2015	Class A, Series I	Class A, Series II
Balance, beginning of year	16,824,904	12,747,483
Redeemed during the year	(1,169,016)	(1,580,975)
Balance, end of year	15,655,888	11,166,508

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.

AUGUST 31, 2016

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

6. REDEEMABLE SHARES *(Cont'd)*

On August 25, 2016 the Board of Directors of the Fund announced that it had approved the re-opening of the Fund on October 24, 2016 to allow for the redemption of approximately 20% of the NAV as at the last day of fiscal 2016. 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 2016/2017 fiscal year as contemplated in the Fund's prospectus disclosure. The Fund anticipates that the next redemption opportunity after October 24, 2016 will not occur until after September 1, 2017.

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, 2016 or 2015.

7. NON-MONETARY TRANSACTIONS

Included in interest from the venture portfolio of Fund II for the year ended August 31, 2016 is $6,790 of interest (2015 - $1,088) earned as a result of various debt refinancing activities. Fund II 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 investment portfolio.

During the year ended August 31, 2016, the Fund exchanged securities with a cost base of $32,551 (2015 - $27,642) for new debt or equity instruments with a fair value of $39,342 (2015 - $28,730).

8. MANAGEMENT FEES, INCENTIVE PARTICIPATION AMOUNT AND OPERATING 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

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

8. MANAGEMENT FEES, INCENTIVE PARTICIPATION AMOUNT AND OPERATING EXPENSES *(Cont'd)*

Covington is entitled to an 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 year ended August 31, 2016 $	Expensed year ended August 31, 2015 $	**Accrued as at August 31, 2016 $**	Accrued as at August 31, 2015 $	**Paid year ended August 31, 2016 $**	Paid year ended August 31, 2015 $
1,612	1,421	**4,024**	3,940	**1,528**	4,312

Directors of the Fund are entitled to receive an annual fee of $50 each 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 $15 per year, 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 period, the Fund paid commissions of $117 (2015 - $192).

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 eigth anniversary of that date of original share issuance and (3) 50% of any IPA paid during the year.

AUGUST 31, 2016

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

9. RELATED PARTY TRANSACTIONS

Included in accrued expenses for Fund II as at August 31, 2016 is $161 (August 31, 2015 - $252) due to Covington for investment/ fund advisory fees.

10. INCOME TAXES

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, 2015, the Fund is in compliance with both requirements set out in the Tax Act and the Ontario Act.

The Fund has capital losses of $27,575 and non-capital losses of $61,958 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: 2036 - $444; 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.

11. FINANCIAL INSTRUMENTS

Fair value hierarchy

The following describes the three-level hierarchy for fair value measurements based on transparency of inputs to the valuating 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.

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

11. FINANCIAL INSTRUMENTS *(Cont'd)*

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, 2016 with comparatives as at August 31, 2015:

	Financial instruments at fair value			
August 31, 2016	**Level 1 $**	**Level 2 $**	**Level 3 $**	**Total $**
Marketable securities	-	-	-	-
Venture investments	8	-	119,428	119,436
Total financial assets	**8**	**-**	**119,428**	**119,436**
August 31, 2015				
Marketable securities	3,528	-	-	3,528
Venture investments	10,802	-	182,648	193,450
Total financial assets	14,330	-	182,648	196,978

During the years ended August 31, 2016 and 2015, there were no transfers between Level 1 and Level 2 of the fair value hierarchy in any of the Funds' assets.

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

	August 31, 2016 $	**August 31, 2015 $**
Level 3 balance, beginning of year	182,648	207,983
New investments	59,881	42,811
Disposals or sales	(62,587)	(34,589)
Net transfers into and/or out of Level 3	(13,021)	(20,244)
Change in unrealized gains/(losses)	(25,679)	(21,004)
Net unrealized gains/(losses)	(21,814)	7,691
Level 3 balance, end of year	**119,428**	182,648
Total change in unrealized gains and losses during the year included in the statement of operations for assets held at end of year	**(16,460)**	(38,176)

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.

AUGUST 31, 2016

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

11. FINANCIAL INSTRUMENTS *(Cont'd)*

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.

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, 2016 and August 31, 2015 as follows:

August 31, 2016		August 31, 2015	
Fair value of privately held investments $	**Decrease/Increase in net assets**	Fair value of privately held investments $	Decrease/Increase in net assets
119,428	**-6.44% to +4.76%**	182,648	-5.50% to +2.41%

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, 2016

Description	Fair value $	Valuation technique	Unobservable inputs	Reasonable possible shift in value	Change in valuation +/- $
Debt	56,964	Estimated realizable value	Probability of collection	-13.95% to +6.12%	-7,945 to +348
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 +961
Underlying funds	7,484	Net asset value per share	Net asset value per share	-8.67% to +17.92%	-649 to +1,341

AUGUST 31, 2016

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

11. FINANCIAL INSTRUMENTS *(Cont'd)*

As at August 31, 2015

Description	Fair value $	Valuation technique	Unobservable inputs	Reasonable possible shift in value	Change in valuation +/- $
Debt	63,418	Estimated realizable value	Probability of collection	-11.36% to +0.19%	-7,260 to +118
Early stage equity	27,328	Last equity round	Discount rate	-0.00% to +0.00%	-
Expansion stage equity	51,922	Comparable trading multiples	Revenue multiple	-3.39% to +3.54%	-1,761 to +1,838
Later stage equity	30,510	Comparable trading multiples	EBITDA multiple	-5.60% to +6.35%	-1,708 to +1,938
Underlying funds	9,470	Net asset value per share	Net asset value per share	-11.99% to +13.39%	-1,136 to +1,268

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.

(b) Foreign currency risk

Foreign currency risk arises from venture investments that are denominated in a currency other than the Canadian dollar, which is the Fund's functional currency. 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, 2016 and August 31, 2015 as follows:

August 31, 2016		August 31, 2015	
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
121	**-2 to +2**	47,094	-942 to +942

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 $	1-3 years $	3-5 years $	Greater than 5 years $
As at August 31, 2016	**74,604**	**7,501**	**-**	**-**
As at August 31, 2015	71,599	7,995	-	-

AUGUST 31, 2016

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

11. FINANCIAL INSTRUMENTS *(Cont'd)*

(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, 2016 - $8 or 0.0% (August 31, 2015 - $14,330 or 6.7%) 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.

The Fund is exposed to weekly redemptions and therefore management attempts to maintain a portion of the NAV in the form of marketable securities which can be disposed of readily. 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. A large number 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. As at August 31, 2016, the Fund does not hold such debt instruments in its portfolio (2015 - $nil).

The Fund holds a portion of is investment portfolio in private debt instruments which can be considered high risk debt instruments. As at August 31, 2016, the Fund had $82,105 (August 31, 2015 - $79,594) 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 $7,338 to investee companies (2015 - $25,527). Should the guarantees be drawn, the amounts would be recorded as follow-on investments (see Note 5).

AUGUST 31, 2016

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

12. ACCOUNTING STANDARDS ISSUED BUT NOT YET ADOPTED

IFRS 9, Financial Instruments ("IFRS")

The final version of IFRS 9, Financial Instruments was issued by IASB in July 2014 and will replace IAS 39 Financial Instruments: Recognition and Measurement. IFRS 9 introduces a model for classification and measurement, a single, forward-looking "expected loss" impairment model and a substantially reformed approach to hedge accounting. The new single, principle based approach for determining the classification of financial assets is driven by cash flow characteristics and the business model in which an asset is held. The new model also results in a single impairment model being applied to all financial instruments, which will require more timely recognition of expected credit losses. It also includes changes in respect of an entity's own credit risk in measuring liabilities elected to be measured at fair value, so that gains caused by the deterioration of an entity's own credit risk on such liabilities are no longer recognized in profit or loss. IFRS 9 is effective for annual periods beginning on or after January 1, 2018, however is available for early adoption. In addition, the entity's own credit changes can be early applied in isolation without otherwise changing the accounting for financial instruments. The Fund is in the process of assessing the impact of IFRS 9.

13. SUBSEQUENT EVENTS

On September 12, 2016 the Fund completed the sale of its investment position in 2210961 Ontario Limited for proceeds that approximated the August 31, 2016 carrying value of this investment.

On October 24, 2016 the Fund entered into an agreement for third party financing with Espresso Capital to provide up to $3.75 million. The Fund has drawn $3.0 million on this facility. As part of securing the debt facility, the Manager was required to advance $1.5 million by way of debt into the Fund. These debt facilities were utilized by the Fund to meet the 20% annual redemption requirement of the Fund.

On October 24, 2016 the Fund was re-opened and subsequently closed to reflect the Fund meeting the 20% annual redemption requirement as contemplated in the Fund's prospectus disclosure. The Fund was previously closed to redemptions on January 18, 2016 after meeting the prior year's 20% annual redemption requirement.

Fund Symbols

Covington Fund II Inc.
CIG912 - Closed
CIG 961 - Closed

Investment and Fund Advisor

Covington Capital Corporation
87 Front Street East, Suite 400
Toronto, ON M5E 1B8

Co-Sponsors

Canadian Police Association
141 Catherine Street, Suite 100
Ottawa, ON K2P 1C3

Association of Canadian Financial Officers
400-2725 Queensview Drive
Ottawa, ON K2B 0A1

Auditor

Ernst & Young LLP
Ernst & Young Tower
P.O. Box 251
Toronto-Dominion Centre
Toronto, ON M5K 1J7

Administrator, Transfer Agent and Registrar

CI Investments Inc.
15 York Street, 2nd Floor
Toronto, ON M5J 0A3
Customer Service: 1 888 746 4751

87 Front Street East
Suite 400
Toronto, ON M5E 1B8
Telephone: 416 365 0060
Facsimile: 416 365 9822
Email: info@covingtonfunds.com
Website: www.covingtonfunds.com

COVINGTON
CAPITAL CORPORATION

SKU CGOF 1071 11/16