# Inner Spirit Holdings Ltd.

Consolidated Financial Statements
For the year ended December 31, 2018 and
the period from incorporation on March 16, 2017 to December 31, 2017
*(Expressed in Canadian Dollars)*

# Independent Auditor's Report

To the Shareholders of Inner Spirit Holdings Ltd.

**Opinion**

We have audited the consolidated financial statements of Inner Spirit Holdings Ltd. and its subsidiaries (the "Company"), which comprise the consolidated statements of financial position as at December 31, 2018 and December 31, 2017, and the consolidated statements of loss and comprehensive loss, changes in shareholders' equity and cash flows for the year ended December 31, 2018 and the period from March 16, 2017 (date of incorporation) to December 31, 2017, and notes to the consolidated financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying consolidated financial statements present fairly, in all material respects, the consolidated financial position of the Company as at December 31, 2018 and December 31, 2017, and its consolidated financial performance and its consolidated cash flows for the year ended December 31, 2018 and the period from March 16, 2017 to December 31, 2017 in accordance with International Financial Reporting Standards.

**Basis for Opinion**

We conducted our audits in accordance with Canadian generally accepted auditing standards. Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Consolidated Financial Statements section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audits of the consolidated financial statements in Canada, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

**Material Uncertainty Related to Going Concern**

We draw attention to Note 1 in the consolidated financial statements, which indicates that the Company had negative cash flows from operating activities of $5,958,925 and incurred a net loss of $11,688,327 during the year ended December 31, 2018 and, as of that date, had a deficit of $12,984,037. As stated in Note 1, these events or conditions, along with other matters as set forth in Note 1, indicate that a material uncertainty exists that may cast significant doubt on the Company's ability to continue as a going concern. Our opinion is not modified in respect of this matter.

**Other Information**

Management is responsible for the other information. The other information comprises Management's Discussion and Analysis.

Our opinion on the consolidated financial statements does not cover the other information and we do not express any form of assurance conclusion thereon.

In connection with our audits of the consolidated financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the consolidated financial statements or our knowledge obtained in the audits or otherwise appears to be materially misstated. We obtained Management's Discussion and Analysis prior to the date of this auditor's report. If, based on the work we have performed on this other information, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.

**Responsibilities of Management and Those Charged with Governance for the Consolidated Financial Statements**

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

In preparing the consolidated financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Company's financial reporting process.

**Auditor's Responsibilities for the Audit of the Consolidated Financial Statements**

Our objectives are to obtain reasonable assurance about whether the consolidated financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with Canadian generally accepted auditing standards will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these consolidated financial statements.

As part of an audit in accordance with Canadian generally accepted auditing standards, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the consolidated financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit 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 Company’s internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company’s ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the consolidated financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the consolidated financial statements, including the disclosures, and whether the consolidated financial statements represent the underlying transactions and events in a manner that achieves fair presentation.
- Obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the Company to express an opinion on the consolidated financial statements. We are responsible for the direction, supervision and performance of the group audit. We remain solely responsible for our audit opinion.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audits and significant audit findings, including any significant deficiencies in internal control that we identify during our audits.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

The engagement partner on the audit resulting in this independent auditor's report is Stephen Bonnell.

MNP LLP

Calgary, Alberta
April 30, 2019

Chartered Professional Accountants

**Inner Spirit Holdings Ltd.**
**Consolidated Statements of Financial Position**
***(Expressed in Canadian Dollars)***
**As at December 31,**

| | Notes | | **2018** | | 2017 |
|---|---|---|---|---|---|
| **ASSETS** | | | | | |
| **Current** | | | | | |
| Cash | | **$** | **2,175,588** | $ | 953,055 |
| Short-term deposits | | | **1,200,000** | | - |
| Accounts receivable | | | **578,842** | | 87,101 |
| Marketable securities | 4 | | **1,262,928** | | - |
| Prepaid investment subscription | 4 | | **149,710** | | - |
| Prepaid expenses and deposits | | | **208,344** | | 91,982 |
| Inventory | 5 | | **2,622,152** | | 680,430 |
| Total current assets | | | **8,197,564** | | 1,812,568 |
| **Non-current** | | | | | |
| Property and equipment | 7 | | **1,349,216** | | 1,001,146 |
| Lease deposits | | | **1,126,639** | | 8,000 |
| Marketable securities | 4 | | **62,257** | | - |
| Goodwill | 6,8 | | **-** | | 2,078,018 |
| Franchise agreements | 6,8 | | **-** | | 475,000 |
| Trademarks | 6,8 | | **-** | | 530,000 |
| Store permits | 6,8 | | **713,993** | | - |
| Total assets | | **$** | **11,449,669** | $ | 5,904,732 |
| | | | | | |
| **LIABILITIES AND SHAREHOLDERS' EQUITY** | | | | | |
| **Current** | | | | | |
| Accounts payable and accrued liabilities | 9 | **$** | **1,294,261** | $ | 539,774 |
| Deferred revenue | 4 | | **303,121** | | - |
| Unredeemed gift card liability | 10 | | **183,531** | | 76,472 |
| Payable to related party | 11 | | **208,779** | | 593,141 |
| Franchise fee deposits | 12 | | **53,750** | | - |
| Total current liabilities | | | **2,043,442** | | 1,209,387 |
| **Non-current** | | | | | |
| Deferred revenue | 4 | | **1,001,934** | | - |
| Franchise fee deposits | 12 | | **1,788,850** | | 460,100 |
| Royalty debt | 13 | | **-** | | 1,000,000 |
| **Total liabilities** | | | **4,834,226** | | 2,669,487 |
| | | | | | |
| **Shareholders' equity** | | | | | |
| Share capital | 15 | | **16,971,660** | | 3,420,871 |
| Share subscriptions | 15 | | **-** | | 1,149,556 |
| Contributed surplus | 15(d) | | **725,137** | | - |
| Warrants | 15(e) | | **1,948,801** | | - |
| Deficit | | | **(12,984,037)** | | (1,335,182) |
| **Total Shareholders' equity of parent** | | | **6,661,561** | | 3,235,245 |
| Non-controlling interest | 17 | | (46,118) | | - |
| **Total Shareholders' equity** | | | **6,615,443** | | 3,235,245 |
| **Total liabilities and shareholders' equity** | | **$** | **11,449,669** | $ | 5,904,732 |

**Nature of operations and going concern (Note 1)**
**Commitments (Note 14)**
**Subsequent events (Note 23)**

**Approved on behalf of the Board of Directors:**

***"Signed"***
**Darren Bondar, Director**

***"Signed"***
**Christopher Gulka, Director**

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

## Consolidated Statements of Loss and Comprehensive Loss
### *(Expressed in Canadian Dollars)*

| | Notes | Year ended December 31, 2018 | Period from incorporation on March 16 to December 31, 2017 |
|---|---|---|---|
| **Revenue** | | | |
| Retail revenue | | **$ 4,970,521** | $ 2,760,613 |
| Royalties | | **205,348** | 110,606 |
| Advertising | | **54,344** | 29,963 |
| Millwork | | **376,369** | - |
| Franchise fees | 12 | **88,750** | - |
| Supply revenue | | **96,053** | 11,090 |
| **Total revenue** | | **5,791,385** | 2,912,272 |
| | | | |
| **Cost of goods sold** | 5 | **3,166,071** | 1,518,595 |
| **Gross profit** | | **2,625,314** | 1,393,677 |
| | | | |
| **Operating expenses** | | | |
| General and administrative | | **2,201,793** | 765,901 |
| Salaries, wages, and benefits | | **2,917,136** | 1,053,889 |
| Occupancy costs | | **1,503,824** | 451,276 |
| Depreciation and amortization | 7,8 | **696,857** | 131,244 |
| Sales and marketing | | **527,038** | 295,484 |
| **Total operating expenses** | | **7,846,648** | 2,697,794 |
| | | | |
| **Operating loss before other expenses** | | **(5,221,334)** | (1,304,117) |
| | | | |
| Share-based compensation | 15(d)(e) | **843,863** | - |
| Unrealized loss on marketable securities | 4 | **2,092,828** | - |
| Impairment loss | 7,8 | **3,526,918** | - |
| Interest expense | 11 | **4,990** | 36,433 |
| Royalty expense | 13 | **5,040** | 58,132 |
| **Loss before income taxes** | | **$ (11,694,973)** | $ (1,398,682) |
| Recovery of deferred taxes | 19 | **-** | 63,500 |
| **Net loss and comprehensive loss** | | **$ (11,694,973)** | $ (1,335,182) |
| | | | |
| **Total net loss and comprehensive loss attributed to** | | | |
| Common shareholders | | **(11,688,327)** | (1,335,182) |
| Non-controlling interest | 17 | **(6,646)** | - |
| **Attributed net loss and comprehensive loss** | | **(11,694,973)** | (1,335,182) |
| | | | |
| **Net loss per share – Basic and diluted** | | **$ (0.09)** | $ (0.03) |
| | | | |
| **Weighted average shares outstanding -Basic and diluted** | | **137,469,525** | 38,786,809 |

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

## Consolidated Statements of Changes in Shareholders' Equity

*(Expressed in Canadian Dollars)*

**For the Year Ended December 31, 2018 and the Period from Incorporation on March 16, 2017 to December 31, 2017**

| | Note | Number | Amount ($) | Share subscriptions ($) | Contributed Surplus ($) | Warrants ($) | Deficit ($) | Non-Controlling Interest ("NCI") ($) | Total ($) |
|---|---|---|---|---|---|---|---|---|---|
| Balance at incorporation | | - | - | - | - | - | - | - | - |
| Issuance of founders shares | 15 | 14,300,000 | 13,000 | - | - | - | - | - | 13,000 |
| Private placements | 15 | 21,940,589 | 832,439 | - | - | - | - | - | 832,439 |
| Watch it! Acquisition | 6,15 | 27,345,516 | 2,485,956 | - | - | - | - | - | 2,485,956 |
| Amalgamation with 204AB | 6,15 | 1,500,000 | 45,000 | - | - | - | - | - | 45,000 |
| Private placement | 15 | 860,000 | 86,000 | - | - | - | - | - | 86,000 |
| Share subscription | 15 | - | - | 1,149,556 | - | - | - | - | 1,149,556 |
| Share issuance costs | 15 | - | (41,524) | - | - | - | - | - | (41,524) |
| Net loss and comprehensive loss | | - | - | - | - | - | (1,335,182) | - | (1,335,182) |
| Balance, December 31, 2017 | | 65,946,105 | 3,420,871 | 1,149,556 | - | - | (1,335,182) | - | 3,235,245 |
| **Private placements** | **15** | **23,553,895** | **2,355,390** | **(1,149,556)** | **-** | **-** | **-** | **-** | **1,205,834** |
| **Debt conversion** | **13,15** | **10,000,000** | **1,000,000** | **-** | **-** | **-** | **-** | **-** | **1,000,000** |
| **Initial public offering** | **15** | **25,000,000** | **2,974,320** | **-** | **-** | **775,680** | **-** | **-** | **3,750,000** |
| **Corporate investments** | **4,15** | **59,776,190** | **7,513,093** | **-** | **-** | **963,101** | **-** | **-** | **8,476,194** |
| **Acquisition of franchisee** | **6,15** | **1,593,334** | **465,000** | **-** | **-** | **79,144** | **-** | **-** | **544,144** |
| **Exercise of warrants** | **15** | **250,000** | **37,500** | **-** | **-** | **(12,500)** | **-** | **-** | **25,000** |
| **Exercise of options** | **15** | **60,000** | **11,032** | **-** | **(5,032)** | **-** | **-** | **-** | **6,000** |
| **Service warrants** | **15** | **-** | **-** | **-** | **-** | **113,694** | **-** | **-** | **113,694** |
| **Agent warrants** | **15** | **-** | **-** | **-** | **-** | **213,334** | **-** | **-** | **213,334** |
| **Share issuance costs** | **15** | **-** | **(805,546)** | **-** | **-** | **(183,652)** | **-** | **-** | **(989,198)** |
| **Share-based compensation** | **15(d)** | **-** | **-** | **-** | **730,169** | **-** | **-** | **-** | **730,169** |
| **Acquisition of shares by NCI** | | **-** | **-** | **-** | **-** | **-** | **39,472** | **(39,472)** | **-** |
| **Net loss and comprehensive loss** | | **-** | **-** | **-** | **-** | **-** | **(11,688,327)** | **(6,646)** | **(11,694,973)** |
| **Balance, December 31, 2018** | | **186,179,524** | **16,971,660** | **-** | **725,137** | **1,948,801** | **(12,984,037)** | **(46,118)** | **6,615,443** |

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

## Consolidated Statements of Cash Flows
*(Expressed in Canadian Dollars)*

| | Notes | | Year ended December 31, 2018 | | Period from incorporation on March 16 to December 31, 2017 |
|---|---|---|---|---|---|
| **Cash provided by (used in) the following activities:** | Notes | | | | |
| **Operating** | | | | | |
| Net loss | | **$** | **(11,694,973)** | $ | (1,335,182) |
| Items not affecting cash | | | | | |
| Deferred tax recovery | 19 | | **-** | | (63,500) |
| Amortization and depreciation | 7,8 | | **696,857** | | 131,244 |
| Inventory write-down | 5 | | **86,834** | | 53,394 |
| Share-based compensation | 15(d)(e) | | **843,863** | | - |
| Unrealized loss on marketable securities | 4 | | **2,092,828** | | - |
| Impairment loss | 7,8 | | **3,526,918** | | - |
| Changes in non-cash working capital balance | 18 | | **(1,511,252)** | | 552,379 |
| Cash flow used in operating activities | | | **(5,958,925)** | | (661,665) |
| **Financing** | | | | | |
| Issuance of share capital, net of issuance costs | 15 | | **9,124,206** | | 2,039,471 |
| Advances from related party | 17 | | **208,779** | | - |
| Repayment to related party | 11 | | **(593,141)** | | 26,389 |
| Non-cash equity transactions | 15 | | **79,144** | | - |
| Cash flow provided by financing activities | | | **8,818,988** | | 2,065,860 |
| **Investing** | | | | | |
| Investment in term deposit | | | **(1,200,000)** | | - |
| Investment in Auxly | 4 | | **350,000** | | - |
| Investment in Newstrike | 4 | | **1,125,000** | | - |
| Investment in prepaid share subscription | 4 | | **(149,710)** | | - |
| Acquisition of property and equipment | 7 | | **(1,362,820)** | | (8,798) |
| Acquisition of franchise store | 6 | | **(400,000)** | | - |
| Acquisition of Watch It! | 6 | | **-** | | (472,342) |
| Amalgamation of 2043246 Alberta Ltd. | 6 | | **-** | | 30,000 |
| Cash flow used in investing activities | | | **(1,637,530)** | | (451,140) |
| **Change in cash** | | | **1,222,533** | | 953,055 |
| **Cash, beginning of year** | | | **953,055** | | - |
| **Cash, end of year** | | **$** | **2,175,588** | $ | 953,055 |

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

## 1. NATURE OF OPERATIONS AND GOING CONCERN

Inner Spirit Holdings Ltd., ("Inner Spirit" or the "Company") was incorporated under the Business Corporations Act (Alberta), on March 16, 2017. The Company was amalgamated under the Business Corporations Act (Alberta) on August 31, 2017 with 2043246 Alberta Ltd. ("204AB") to continue as Inner Spirit Holdings Ltd.

The Company has four subsidiaries, Spirit Leaf Inc., Spirit Leaf Corporate Inc., and Spirit Leaf Macleod Inc. collectively ("Spirit Leaf") and Watch It! Consolidated Ltd. ("Watch It!"). Spirit Leaf Inc's primary business is the sale and ongoing support of franchise cannabis dispensaries across Canada. Spirit Leaf Corporate Inc., and Spirit Leaf Macleod's primary business is the sale of cannabis and accessories, through corporate stores. Watch It!, which has the primary business of the on-going support of retail watch store franchises and the sale of watches and accessories through retail outlets across Canada and website sales.

The Company's registered office is located at Suite 1600 Dome Tower, 333 7th Avenue S.W, Calgary, AB, T2P 2Z1.

These consolidated financial statements ("Financial Statements") have been prepared on a going concern basis, which assumes that the Company will continue to operate for the foreseeable future and will be able to realize its assets and discharge its liabilities in the normal course of business.

During the year ended December 31, 2018, the Company had negative cash flows from operating activities of $5,958,925, incurred a net loss of $11,688,327 (2017 - $1,335,182) and, as of that date, the Company has an accumulated deficit of $12,984,037 (2017 - $1,335,182). The Company will require additional financing in order to conduct its planned business operations, meet its ongoing levels of corporate overhead and discharge its liabilities and commitments as they come due, all of which may cast significant doubt about the Company's ability to continue as a going concern.

Management's view is that the success of the Company is dependent upon financing its capital requirements and achieving profitable operations. The Company has been successful in completing an initial public offering and completing private placements from public investors and strategic partners, who continue to support the Company.

The Financial Statements do not reflect adjustments that would be necessary if the going concern basis was not appropriate. Consequently, adjustments could then be necessary to the carrying value of assets and liabilities, the reported expenses and their classifications. Such adjustments if required, could be material.

## 2. BASIS OF PRESENTATION

### Statement of compliance

The Company applies International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB") and interpretations issued by the International Financial Reporting Interpretations Committee ("IFRIC") in effect for the period beginning January 1, 2018.

These Financial Statements were approved and authorized by the Board of Directors on April 30, 2019.

### Basis of measurement

The Financial Statements have been prepared on historical cost basis except for certain financial instruments and marketable securities which are measured at fair value as explained in the accounting policies.

## 2. BASIS OF PRESENTATION (CONTINUED)

### Basis of consolidation

The Financial Statements include the ownership percentages of Inner Spirit's subsidiaries:

| Entity Name | Ownership Percentage |
|---|---|
| Spirit Leaf Inc. | 100% |
| Spirit Leaf Corporate Inc. | 100% |
| Spirit Leaf Macleod Inc. | 50.1% |
| Watch It! Consolidated Ltd. | 100% |

The Company has consolidated the assets, liabilities, revenues and expenses of the subsidiaries after the elimination of inter-company transactions and balances.

A subsidiary is an entity controlled by the Company. Control exists when the Company has the power, directly or indirectly, to govern the financial and operating policies of an entity so as to obtain benefits from its activities. This control is evidenced through, among other things, owning more than 50% of the voting rights or currently exercisable potential voting rights of a company's share capital. The financial statements of the subsidiary are included in the Financial Statements of the Company from the date that control commences until the date that control ceases.

### Non-controlling interest

Non-controlling interest represent equity interests in subsidiaries owned by outside parties. The share of net assets of subsidiaries attributable to non-controlling interests is presented as a component of shareholders' equity. Changes in the Company's ownership interest in subsidiaries that do not result in a loss of control are accounted for as equity transactions.

Non-controlling interest consists of the non-controlling interest at the date of the original acquisition plus the non-controlling interest share of changes in equity since the date of acquisition. The Company owns 50.1% of the common shares outstanding of its subsidiary, Spirit Leaf Macleod Inc. These consolidated financial statements include 100% of the assets and liabilities related to Spirit Leaf Macleod Inc., and include a non-controlling interest representing 49.9% of Spirit Leaf Macleod Inc's assets and liabilities not owned by the Company.

### Functional currency

These Financial Statements have been prepared in Canadian dollars, which is the Company's functional and presentation currency.

### Significant accounting judgments and estimates

The preparation of these Financial Statements requires management to make judgments, estimates and assumptions that affect the application of policies and reported amounts of assets and liabilities, and revenue and expenses. The estimates and associated assumptions are based on historical experience and various other factors that are believed to be reasonable under the circumstances, the results of which form the basis of making the judgments about carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

The estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognized in the period in which the estimate is revised if the revision affects only that period or in the period of the revision and future periods if the review affects both current and future periods. Significant assumptions about the future that management has made that could result in a material adjustment to the carrying amounts of assets and liabilities, in the event that actual results differ from assumptions made, relate to, but are not limited to, the following:

#### *Going concern*

- Determining if the Company has the ability to continue as a going concern is dependent on its ability to achieve profitable operations. Certain judgments are made when determining if the Company will achieve profitable operations.

## 2. BASIS OF PRESENTATION (CONTINUED)

### Significant accounting judgments and estimates (continued)

***Expected credit losses***

- The Company's accounts receivables are typically short-term in nature and the Company recognizes an amount equal to the lifetime expected credit losses ("ECL"). The Company measures loss allowances based on historical experience and including forecasted economic conditions. The amount of ECLs is sensitive to changes in circumstances of forecast economic conditions.

***Inventory***

- Inventory is carried and the lower of cost and net realizable value; in estimating net realizable value, the Company makes estimates related to obsolescence, future selling prices, seasonality, customer behavior, and fluctuations in inventory levels.

***Determining CGUs***

- For the purpose of assessing impairment of non-financial assets, the Company must determine its cash-generating units (CGUs). Assets are grouped into CGUs at the lowest level of separately identified cash flows. The determination of a CGU is based on management's judgment and is an assessment of the smallest group of assets that generate cash inflows independently of other assets. Management has determined that each corporate store in Spirit Leaf and Watch it! is its own CGU.

***Impairment testing of PP&E, goodwill, and indefinite life intangible assets***

- PP&E, goodwill and indefinite life intangible assets are assessed for impairment at least annually, and whenever there is an indication that the asset may be impaired. The Company determines the fair value of its CGU groupings and indefinite life intangible assets using discounted cash flow models corroborated by other valuation techniques.

  The process of determining these fair values requires the Company to make estimates and assumptions of a long-term nature regarding discount rates, projected revenues, margins, as applicable, derived from past experience, actual operating results and budgets. These estimates and assumptions may change in the future due to uncertain competitive and economic market conditions or changes in business strategies.

***Depreciation***

- The Financial Statements include estimates of the useful economic life of property and equipment. Due to varying assumptions required to be made with regards to useful life of these assets, the depreciation recorded by management is based on their best estimate and in this regard may be significantly different from those determined based on future operational results.

***Amortization of intangible assets***

- The Financial Statements include estimates of the useful economic life of intangible assets. Due to varying assumptions required to be made with regards to future recoverability of these assets, the amortization recorded by management is based on their best estimate and in this regard may be significantly different from those determined based on future operational results.

***Deferred tax assets***

- Deferred tax assets, including those arising from tax loss carry-forwards, require management to assess the likelihood that the Company will generate sufficient taxable income in future periods in order to utilize recognized deferred tax assets. Assumptions about the generation of future taxable profits depend on management's estimates of future cash flows. In addition, future changes in tax laws could limit the ability of the Company to obtain tax deductions in future periods. To the extent that future cash flows and taxable income differ significantly from estimates, the ability of the Company to realize the net deferred tax assets recorded at the reporting date could be impacted.

## 2. BASIS OF PRESENTATION (CONTINUED)

### Significant accounting judgments and estimates (continued)

***Estimate on share-based compensation and warrants***

- The Company issues warrants and stock options to directors, officers and other consultants. The Company employs the fair value method of accounting for stock options and warrants. The determination of the share-based compensation expense for stock options and warrants requires the use of requires judgment as to the appropriate valuation model and the inputs for the model require assumptions including the rate of forfeiture of options and warrants granted, the expected life of the option or warrant, the expected volatility of the Company's share price, the risk-free interest rate and expected dividends.

## 3. SIGNIFICANT ACCOUNTING POLICIES

### Cash

Cash includes petty cash, store cash floats, and cash on deposit at banking institutions with maturities of 3 months or less.

### Short-term deposits

Short term deposits include cash on deposit at banking institutions with maturities of greater than 3 months.

### Foreign currency transactions

Transaction amounts denominated in foreign currencies are translated into their Canadian dollar equivalents at exchange rates prevailing at the transaction dates. Carrying values of monetary assets and liabilities reflect the exchange rates at the financial position date. Gains and losses on translation or settlement are included in the determination of loss and comprehensive loss.

### Inventory

Inventory is valued at the lower of cost and net realizable value. Net realizable value is the estimated selling price in the ordinary course of business, less estimated costs of selling the final product. Cost is determined by the weighted average method and comprises of direct purchase costs.

Inventory is written down to its net realizable value when the cost of inventory is estimated to be unrecoverable due to obsolescence, damage, or declining selling prices.

### Property and equipment

Property and equipment ("P&E") are initially recorded at cost, net of accumulated depreciation and any accumulated impairment losses. Depreciation is provided using the following methods at rates intended to depreciate the costs of the assets over their estimated use lives less any estimated residual values.

| Asset | Method | Rate |
|---|---|---|
| Computer equipment | Declining balance | 55% -100% |
| Furniture and fixtures | Declining balance | 20% |
| Leasehold improvements | Straight-line | Term of lease |

## 3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

### Intangible assets

Intangible assets consist of franchise agreements, trademarks, and store permits. Impairment losses for intangible assets where the carrying value is not recoverable are measured based on fair value. Fair value is calculated by using discounted cash flows.

The fair value of franchise agreements acquired in a business combination are determined using the multi-period excess earnings method, whereby the subject asset is valued after deducting a fair return on all other assets that are part of creating the related cash flows.

The fair value of trademarks acquired in a business combination are determined using the multi-period excess earnings method or the relief of royalty method, whereby the value of the brand is equal to the royalty savings from having ownership as opposed to licensing the brand.

Amortization is recognized in the immediately in the consolidated statement of loss and comprehensive loss on a straight-line basis over the estimated useful lives of intangible assets such as store permits, other than indefinite-life intangible assets, such as goodwill and trademarks, from the date that they are available for use. The estimated useful live of the franchise agreements is 10 years.

### Goodwill

Goodwill arises on the acquisition of subsidiaries and is tested for impairment annually or more frequently if events or circumstances indicate that the carrying amount may not be recoverable. Goodwill is initially recognized as the excess of the purchase price over the fair value of the net assets acquired in a business combination. Subsequently, goodwill is measured at cost less accumulated impairment losses.

### Business combinations

The Company assesses whether an acquisition should be accounted for as an asset acquisition or a business combination under IFRS 3 Business Combinations (“IFRS 3”). This assessment requires management to make judgments on whether the assets acquired, and liabilities assumed constitute a business as defined in IFRS 3 and if the integrated set of activities, including inputs and processes acquired, are capable of being conducted and managed as a business and the Company obtains control of the business inputs and processes. The Company’s acquisition of 204AB has been accounted for as an asset acquisition and the acquisition of Watch It! was accounted for as a business combination (Note 6).

The Company measures goodwill as the fair value of the consideration transferred, less the net recognized amount (fair value) of the identifiable assets acquired and liabilities assumed, all measured as of the acquisition date. When the excess is negative, a bargain purchase gain is recognized immediately in the consolidated statement of loss and comprehensive loss. Costs, other than those associated with the issue of debt or equity securities, that the Company incurs in connection with a business combination are expensed as incurred.

### Impairment of financial assets

*(i)* **Financial assets**

At each statement of financial position reporting date, an assessment is made whether there is objective evidence that a financial asset is impaired based on expected credit loss information. For the Company’s financial assets measured at amortized cost, loss allowances are determined based on the expected credit loss over the asset’s lifetime. Expected losses are a probability-weighted estimate of credit-losses, considering possible default events over the expected life of a financial asset.

All impairment losses are recognized in the consolidated statement of loss and comprehensive loss.

An impairment loss is reversed if the reversal can be related objectively to an event occurring after the impairment loss was recognized. For financial assets measured at amortized costs the reversal is recognized in the consolidated statement of loss and comprehensive loss.

## 3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

### Impairment of financial assets (continued)

*(ii)* **Non-financial assets**

The carrying amounts of P&E are reviewed at each reporting date to determine whether there is any indication of impairment. If such an indication exists, the estimated recoverable amount is calculated. For the purpose of impairment testing, P&E assets are grouped together into the smallest group of assets that generates cash inflows that are largely independent of the cash flows of other assets or group of assets. The recoverable amount of an asset or cash generating unit (“CGU”) is the greater of its fair value less costs of disposal ("FVLCD") and its value in use ("VIU"). FVLCD is the amount obtainable from the sale of an asset or CGU in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal or in the case of a lack of comparable transactions, based upon discounted after tax cash flows. VIU is determined by estimating the present value of the future net cash flows expected to be derived from the continued use of the asset or cash generating unit. An impairment loss is recognized in the consolidated statement of loss and comprehensive loss if the carrying amount of an asset or CGU exceeds its estimated recoverable amount.

For the purposes of goodwill impairment testing, goodwill acquired in a business combination is allocated to the CGU, or the group of CGUs, that is expected to benefit from the synergies of the combination. This allocation is subject to an operating segment ceiling test and reflects the lowest level at which that goodwill is monitored for internal reporting purposes. An impairment loss is recognized if the carrying amount of an asset or its CGU exceeds its estimated recoverable amount. Impairment losses are recognized in the consolidated statement of loss and comprehensive loss. Impairment losses, other than those relating to goodwill, are evaluated for potential reversals when events or changes in circumstances warrant such consideration.

The carrying values of finite-life intangible assets are reviewed for impairment whenever events or changes in circumstances indicate that their carrying amounts may not be recoverable. Additionally, the carrying values of goodwill and indefinite life intangibles are tested annually for impairment.

In respect of other assets, impairment losses recognized in prior years are assessed at each reporting date for any indications that the losses have decreased or no longer exist. An impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount. An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortization, if no impairment loss had been recognized.

### Leases

Assets under operating leases are not recognized in the Company’s statement of financial position. Payments made under operating leases are recognized in the consolidated statement of loss and comprehensive loss on a straight-line basis over the term of the lease.

### Provisions

A provision is recognized when the Company has a present legal or constructive obligation as a result of a past event, it is probable that an outflow of economic benefits will be required to settle the obligation, and the amount of the obligation can be reliably estimated. The amount of a provision is the best estimate of the consideration at the end of the reporting period. Provisions measured using estimated cash flows required to settle the obligation are determined by discounting the expected future cash flows at a pre-tax rate that reflects current market assessments of the time value of money and, where appropriate, the risks specific to the liability.

A provision for onerous contracts is recognized when the expected benefits to be derived by the Company from a contract are lower than the unavoidable cost of meeting its obligations under the contract. The Company has no material provisions as at December 31, 2018.

## 3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

### Share capital

Common shares are classified as equity. The share capital represents the amount received upon issuance of shares. Incremental costs directly attributable to the issuance of shares are recognized as a deduction from the proceeds in equity in the period in which the transaction occurs.

### Stock options and warrants

The fair value of stock options and warrants granted is recognized using the Black-Scholes option pricing model. Measurement inputs include the Company's share price on the measurement date, the exercise price of the option, the expected volatility of the Company's shares, the expected life of the options, expected dividends, expected forfeitures and the risk-free rate of return. The Company estimates volatility based on the historical share price of similar companies in the publicly traded markets. The expected life of the options is based on historical experience and estimates of the holder's behavior. Dividends are not factored in as the Company does not expect to pay dividends in the foreseeable future. Management also makes an estimate of the number of options that will be forfeited, and the rate is adjusted to reflect the actual number of options that actually vest. The fair value of the exercised warrants are derecognized from warrants and recognized in share capital. The Company records the cumulative share-based compensation as contributed surplus. When options are exercised, contributed surplus is reduced and share capital is increased by the amount of accumulated share-based compensation for the exercised security. Any consideration received on the exercise of stock options is credited to share capital.

Stock-based compensation transactions with parties other than employees are measured at the fair value of the goods or services received, except where that fair value cannot be estimated reliably, in which case they are measured at the fair value of the equity instruments granted, measured at the date the entity obtains the goods or the counterparty renders the service. It is presumed that the fair value of services provided by employees cannot be estimated reliably, and therefore the value of the warrants issued must be used.

### Loss per share

The Company presents basic and diluted loss per share for its common shares, calculated by dividing the loss attributable to common shareholders of the Company by the weighted average number of common shares outstanding during the period. Diluted loss per share is determined by adjusting the loss attributable to common shareholders and the weighted average number of common shares outstanding for the effects of all warrants and options outstanding that may add to the total number of common shares to the extent that that are not antidilutive.

### Revenue

#### *Retail revenue*

Retail revenue consists of sales through the corporate stores and e-commerce operations. Revenue at corporate stores is recognized at point of sale when the customer takes control of the goods or service in an amount that reflects the consideration the Company expects to receive in exchange for the goods or services. The Company considers its performance obligations to be satisfied at point of sale. The Company's goods and services are generally capable of being distinct and are accounted for as a separate performance obligation. Sales through ecommerce operations are recognized when the customer takes control of the goods or services upon delivery in an amount that reflects the consideration the Company expects to receive in exchange for the goods or services.

It is the Company's policy to sell merchandise with a limited right to return. Returns are only provided through exchanges or the issuance of a gift certificate. Gift certificates that have not been redeemed are recorded as an unredeemed gift card liability.

#### *Royalty revenue*

Ongoing royalty fees, which are determined on a formula basis in accordance with the terms of the relevant franchise agreement, are recognized as revenue when the contractual performance obligations have been achieved or other service related performance obligations have been completed.

## 3. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

### *Advertising revenue*
Advertising and franchise revenue is recognized when a contractual exchange agreement has been entered into, the performance obligation has been performed, and the customer accepts the results of the services, in an amount that reflects the consideration the Company expects to receive in exchange for the goods or services.

### *Millwork and supply revenue*
Millwork and miscellaneous revenue is recognized when a contractual exchange agreement has been entered into, the performance obligation has been performed, and the customer accepts the results of the services, in an amount that reflects the consideration the Company expects to receive in exchange for the goods or services.

### *Franchise fee revenue*
Franchise fees are recognized at a point in time when the Company satisfies the performance obligation and the franchise begins operations.

### Income taxes
Income tax on the income or loss for the period comprises of current and deferred tax. Income tax is recognized in the consolidated statement of loss and comprehensive loss except to the extent that it relates to items recognized directly in equity, in which case it is recognized in equity.

Current tax expense is the expected tax payable on the taxable income for the period, using tax rates enacted or substantively enacted at period end, adjusted for amendments to tax payable with regards to previous periods.

Deferred tax is recognized using the asset and liability method, based on temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. Temporary differences are not provided for goodwill that is not deductible for tax purposes and the initial recognition of assets or liabilities that affect neither accounting nor taxable income. The amount of deferred tax provided is based on the expected manner of realization or settlement of the carrying amount of assets and liabilities, using tax rates enacted or substantively enacted at the consolidated financial position reporting date.

A deferred tax asset is recognized only to the extent that it is probable that future taxable income will be available against which the asset can be utilized.

### Segment reporting
A segment is a distinguishable component of the Company that is engaged either in providing related products (business segment) and that is subject to risks and returns that are different from those of other segments. Segment information is presented in respect of the Company's business segments. The Company's primary format for segment reporting is based on business segments. The business segments are determined based on the Company's management and internal reporting structure. The Company has three segments: Inner Spirit, Spirit Leaf, and Watch It!.

Segment results, assets and liabilities include items directly attributable to a segment as well as those that can be allocated on a reasonable basis. Unallocated items comprise mainly other investments and related revenue, loans and borrowings and related expenses, corporate assets (primarily the Company's headquarters) and head office expenses. Segment capital expenditure is the total cost incurred during the period to acquire property, and equipment and intangible assets, other than goodwill.

### Financial instruments
a) Financial assets - Pursuant to IFRS 9 – *Financial instruments ("IFRS 9")*, the classification of financial assets is based on the Company's assessment of its business model for holding financial assets and the contractual terms of the cash flows. The classification categories are as follows:

## 3.SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

### Financial instruments (continued)

- Financial assets measured at amortized cost: assets that are held within a business model whose objective is to hold assets to collect contractual cash flows and its contractual terms give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.
- Financial assets at fair value through other comprehensive income ("FVOCI"): assets that are held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets and its contractual terms give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.
- Financial assets at fair value through profit or loss ("FVTPL"): assets that do not meet the criteria for amortized cost or FVOCI.

Financial assets measured at amortized cost are measured at cost using the effective interest method. The amortized cost is reduced by impairment losses at an amount equal to the lifetime expected credit losses that result from all possible default events over the expected life of the financial instrument. Loss allowances for financial assets measured at amortized cost are deducted from the gross carrying amounts of the assets and the loss is recognized in the consolidated statements of loss and comprehensive loss. When a trade receivable is uncollectible, it is written off against the allowance for doubtful accounts.

Financial assets are derecognized when the contractual rights to the cash flows from the financial asset expire or when the contractual rights to those assets are transferred.

Marketable securities have been classified as FVTPL. Cash, short-term deposits, and accounts receivable has been classified as amortized cost.

b) Financial liabilities - The classification of financial liabilities is determined by the Company at initial recognition. The classification categories are as follows:

- Financial liabilities measured at amortized cost: financial liabilities initially measured at fair value less directly attributable transaction costs and are subsequently measured at amortized cost using the effective interest method. Interest expense is recognized in the consolidated statement of loss and comprehensive loss.
- Financial liabilities measured at fair value through profit or loss: financial liabilities measured at fair value with changes in fair value and interest expense recognized in the consolidated statement of loss and comprehensive loss.

Financial liabilities are derecognized when the obligation in discharged, cancelled or expired.

Accounts payable and accrued liabilities, refundable franchise fee deposits, payable to related party, and royalty debt have been classified as amortized cost.

### Recently adopted accounting pronouncements

*IFRS 9, Financial Instruments*
IFRS 9 introduces new requirements for classifying and measuring financial instruments. The standard became effective for fiscal years beginning on or after January 1, 2018. IFRS 9 affects the classification and measurement of financial assets and financial liabilities and the recognition of expected credit losses. The Company adopted IFRS 9 effective January 1, 2018 on a retrospective basis. The prior year comparative information has not been adjusted with respect to the adoption of IFRS 9's classification and measurement requirements as the adoption of IFRS 9 did not result in any material changes.

IFRS 9 replaces the 'incurred loss' model in IAS 39 with an 'expected credit loss' (ECL) model for calculating impairment. The new impairment model applies to financial assets measured at amortized cost. Under IFRS 9, credit losses are recognized earlier than under IAS 39. The Company applied the simplified approach to providing for expected credit losses prescribed by IFRS 9, which requires the use of the lifetime expected loss provision for all accounts receivable.

## 3.SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

The following table summarizes the classification impacts of the adoption of IFRS 9:

| Financial Instrument | Previous Classification under IAS 39 | New Classification under IFRS 9 |
|---|---|---|
| Cash | Loans and receivables | Amortized cost |
| Short-term deposits | Loans and receivables | Amortized cost |
| Accounts receivable | Loans and receivables | Amortized cost |
| Marketable securities | Held for Trading | FVTPL |
| Accounts payable and accrued liabilities | Other liabilities | Amortized cost |
| Refundable franchise fee deposits | Other liabilities | Amortized cost |
| Payable to related party | Other liabilities | Amortized cost |
| Royalty debt | Other liabilities | Amortized cost |

There were no adjustments to the carrying amounts of financial instruments as a result of the measurement classification category changes from International Accounting Standard 39- Financial Instruments: Recognition and Measurement (“IAS 39”) to IFRS 9.

*IFRS 15, Revenue from contracts with customers*

On May 28, 2014 the IASB issued IFRS 15. The standard replaces IAS 11, Construction Contracts, IAS 18, Revenue, and related interpretations. The standard is effective for annual periods beginning on or after January 1, 2018. The standard outlines a single comprehensive model for entities for revenue recognition arising from contracts with customers.
The Company has completed its evaluation of the impact of IFRS 15 on its Financial Statements. The Company’s practices of revenue recognition are unchanged upon adoption of this standard, therefore, the adoption of IFRS 15 did not result in a material impact to the Financial Statements. The Company has elected to apply the standard on a modified retrospective basis. Under this approach, the 2017 comparative period was not restated. There was no cumulative transitional adjustment to the opening retained earnings balance required.

### Future accounting pronouncements issued but not yet applied

The IASB issued IFRS 16, Leases, in January 2016. The new standard replaces IAS 17, Leases. Under the new standard, more leases will be recognized on the statement of financial position for lessees, with the exception of leases with a term not greater than 12 months and “small value” leases. Lease accounting for lessors remains substantially the same as existing guidance.

The standard is effective for years beginning on or after January 1, 2019, IFRS 16 is required to be adopted either retrospectively or using a modified retrospective approach. The modified retrospective approach does not require restatement of prior period financial information as it recognizes the cumulative effect of IFRS 16 as an adjustment to opening retained earnings and applies the standard prospectively. The Company plans to use the modified retrospective approach for its adoption of IFRS 16 effective January 1, 2019.

At December 31, 2018, the Company’s IFRS 16 transition project consists of three key phases: project scoping, impact analysis, and implementation phase. The Company anticipates the adoption of IFRS 16 will have a material impact on the consolidated statement of financial position primarily due to the capitalization of real estate leases which are currently recognized as operating leases in the consolidated statement of loss and comprehensive loss.

On initial adoption, the Company intends to use the following practical expedients permitted under the standard:

- Apply a single discount rate to a portfolio of leases with similar characteristics;
- Account for leases with a remaining term of less than 12 months as at January 1, 2019 as short-term leases;
- Account for lease payments as an expense and not recognize a ROU asset if the underlying asset is of low dollar value; and,
- Use hindsight in determining the lease term where a contract contains terms to extend or terminate the lease.

A process for identifying potential leases under IFRS 16 has been established and the Company is currently implementing changes to policies, internal controls, information systems, and business and accounting processes.

## 4. MARKETABLE SECURITIES

i) On February 6, 2018, the Company issued 15,000,000 common shares at $0.10 per share to Auxly Cannabis Group Inc., formerly Cannabis Wheaton Income Corp. ("Auxly"), in consideration for Auxly: (i) paying to the Company the sum of $350,000; (ii) issuing to the Company 674,418 common shares in the capital of Auxly; and (iii) issuing to the Company 1,250,000 share purchase warrants, each share purchase warrant entitling the Company to purchase a common share in the capital of Auxly at an exercise price of $2.53 for a period of two (2) years and will vest on a performance-based schedule triggered by the opening of a pre-determined number of future Spirit Leaf locations. The agreement with Auxly also provides an anti-dilution right (the "Auxly Anti-Dilution Right"), allowing Auxly to maintain its ownership percentage in the Company's voting securities in the event that the Company issues equity securities in the capital of the Company until July 31, 2018. Also, as part of the agreement, the Company will allocate 50% of its distribution locations' floor space for Auxly products.

As at February 6, 2018, the Auxly warrants were valued using the Black Scholes model, with the following assumptions, (a) risk free interest rate of 1.80%, and (b) stock price volatility of 110%.

The Company has allocated $1,305,055 of the investment in the Company as deferred revenue, which represents the difference between the fair value of consideration received and the fair value of the Company's shares transferred to Auxly (see Note 15(b)vii).

As at December 31, 2018, none of this deferred revenue has been recognized, since the Company has not yet entered into an Irrevocable Commercial Rights Agreement with Auxly until January 31, 2019. The agreement has given Auxly the commercial right to supply the Company up to 50% of all of its cannabis and cannabis inputs and profit sharing up to January 8, 2023. Based on their agreement, the Company has determined to recognize the deferred revenue straight line over the agreement terms and has therefore recorded $303,121 as a current liability on the consolidated statement of financial position.

As at December 31, 2018, Auxly shares and the Auxly warrants were marked down to fair market value based on the closing Auxly share price on that date. The Auxly warrants were marked down to fair market value based on the Black Scholes model using with the following assumptions, (a) risk free interest rate of 1.91%, and (b) stock price volatility of 93.50%.

| | Auxly Shares | Auxly Warrants | Total |
|---|---|---|---|
| Fair market value, February 6, 2018 | $ 1,267,906 | $ 1,187,149 | $ 2,455,055 |
| Unrealized loss | (654,186) | (1,050,503) | (1,704,689) |
| **Fair market value, December 31, 2018** | **613,720** | **136,646** | **750,366** |
| **Current portion** | **$ 613,720** | **$ 109,317** | **$ 723,037** |

ii) On July 31, 2018 the Company closed its investment transaction with Newstrike Brands Ltd. ("Newstrike"), pursuant to which both Newstrike and the Company have acquired equity interests in each other. Newstrike made an aggregate investment in the Company valued at $2.25 million comprised of $1,125,000 in cash and 1,250,000 Newstrike common shares issued at closing at a price of $0.90. Newstrike has also issued 1,125,000 warrants to purchase Newstrike common shares at an exercise price of $0.99, a term of 24 months and will vest on a performance-based schedule triggered by the opening of a pre-determined number of future Spirit Leaf locations.

In consideration for Newstrike's investment in Inner Spirit, Inner Spirit issued Newstrike, 15,000,000 units of the Company ("Units") at a price of $0.15 per Unit. Each Unit was comprised of one common share of the Company and one-half of a common share purchase warrant, exercisable at $0.30 per share for a period of two (2) years following the date of issuance. The Company recorded these equity instruments at the fair value of consideration received.

As at July 31, 2018, the Newstrike warrants were valued using the Black Scholes model, with the following assumptions, (a) risk free interest rate of 2.05%, and (b) stock price volatility of 139%.

## 4. MARKETABLE SECURITIES (CONTINUED)

As at December 31, 2018, Newstrike shares were marked down to fair market value based on the closing Newstrike share price on that date. The Newstrike warrants were marked down to fair market value based on the Black Scholes model using with the following assumptions, (a) risk free interest rate of 1.91%, (b) stock price volatility of 91% and the closing Newstrike stock price.

| | Newstrik Shares | Newstrike Warrants | Total |
|---|---|---|---|
| Fair market value, July 31, 2018 | $ 637,500 | $ 325,458 | $ 962,958 |
| Unrealized loss | (150,000) | (238,139) | (388,139) |
| **Fair market value, December 31, 2018** | **487,500** | **87,319** | **574,819** |
| **Current portion** | **$ 487,500** | **$ 52,319** | **$ 539,891** |

iii) During the year ended December 31, 2018, the Company made a prepaid subscription of US$110,000 ($149,710 Cdn.) in an investment in Hightimes Holding Corp.("Hightimes").

iv) Subsequent to the year ended December 31, 2018, the Company sold 674,418 shares of Auxly and 1,250,000 shares of Newstrike for gross proceeds of $1,174,854.

## 5. INVENTORY

| As at December 31, | **2018** | 2017 |
|---|---|---|
| Watch it! merchandise | **$939,916** | $680,430 |
| Spirit Leaf merchandise | **265,196** | - |
| Millwork | **1,417,040** | - |
| | **$2,622,152** | $680,430 |

Included in cost of sales for the year ended are inventory write-downs for damaged inventory and inventory shrinkage in the amount of $86,834 (2017 - $53,394).

Inventory costs included in cost of sales:

| | **Year ended December 31, 2018** | Period ended from incorporation on March 16 to December 31, 2017 |
|---|---|---|
| Expensed inventories Watch it! | **$2,530,816** | $1,465,201 |
| Expensed inventories Spirit Leaf | **74,992** | - |
| Expensed inventories millwork | **358,623** | - |
| | **$2,964,431** | $1,465,201 |

## 6. ACQUISITIONS

### Business combination

i) On July 15, 2017, the Company entered into a share purchase agreement with Watch It! pursuant to which the Company acquired 100% of all of the issued and outstanding shares of Watch It! for 27,345,516 of common shares in the Company at a deemed price of $0.09 per share, for total consideration of $2,485,956. As a result of the acquisition, Watch It! became 100% directly owned subsidiary of the Company. The acquisition was treated as an issuance of common shares by the Company.

As Watch It! is an operating business in accordance with IFRS 3, the transaction has been treated as a business combination, using the acquisition method. The purchase consideration has been allocated based on the Company's estimated fair value of the identifiable assets acquired and liabilities assumed. The goodwill and trademarks acquired are considered to have an indefinite useful life as it relates to the ongoing operations of the Watch It! stores owned by the Company. The assets will be tested for impairment on an annual basis if indicators of impairment are present.

The acquisition of Watch It was calculated as follows:

| As at, | | **July 14, 2017** |
|---|---|---|
| Consideration: | | |
| 27,345,516 Class A Common Shares at $0.0909 per share | $ | 2,485,956 |
| Loan from Inner Spirit Holdings Ltd. | | 298,000 |
| Cash | | 174,342 |
| **Total consideration** | **$** | **2,958,298** |
| | | |
| Assets (liabilities) acquired | | |
| Working capital | $ | 580,385 |
| Property and equipment | | 1,098,572 |
| Franchise agreements | | 500,000 |
| Trademarks | | 530,000 |
| Goodwill | | 2,078,018 |
| Payable to shareholder | | (566,752) |
| Royalty debt | | (1,000,000) |
| Other debt | | (198,425) |
| Deferred tax liability | | (63,500) |
| **Net assets acquired** | **$** | **2,958,298** |

Goodwill arose in the acquisition because the cost of acquisition included amounts in relation to the benefit of expected revenue growth and future market development. These benefits are not recognized separately from goodwill because they do not meet the recognition criteria for identifiable intangible assets.

The revenue and operating income (loss) included in the consolidated statement of loss and comprehensive loss since July 14, 2017 is $2,911,127 and $(224,857), respectively. Had the acquisition occurred on January 1, 2017, the consolidated statement of loss and comprehensive loss for the year ended December 31, 2017 would have shown revenue and operating income (loss) of $5,039,793 and $(1,022,308) respectively. These pro-forma amounts are estimated based on the operation of the acquired business prior the business combination by the Company. Since the acquisition target was being restructured through bankruptcy proceedings, at the time of the acquisition, the historical results are not indicative of the financial results going forward.

## 6. ACQUISITIONS (CONTINUED)

### Asset acquisitions

ii) On August 31, 2017, the Company amalgamated with 204AB. 204AB's net assets consisted of the following:

| | | |
|---|---|---|
| Cash | $ | 30,000 |
| Deposits and prepaid expenses | | 30,000 |
| Accounts payable and accrued liabilities | | (5,000) |
| Promissory note | | (10,000) |
| Net assets acquired | $ | **45,000** |
| Consideration paid | | |
| 1,500,000 Common Shares | $ | **45,000** |

iii) During the year ended, December 31, 2018, the Company, through its wholly-owned subsidiary Spirit Leaf Corporate Inc., entered into an agreement with an arm's length party to purchase a permit towards a provisionally approved recreational cannabis dispensary in the Beltline area of Calgary, Alberta. Total consideration paid for the permit was $400,000 through the issuance of 1,333,334 Inner Spirit common shares based on a deemed price of $0.30 per share (Note 15(b)(xiv).

iv) During the year ended December 31, 2018, the Company, through its wholly-owned subsidiary Spirit Leaf Corporate Inc., has entered into an agreement with an arm's length party to purchase all the assets of Indica Jasper Inc., constituting a substantially completed and provisionally approved recreational cannabis dispensary in the town of Jasper, Alberta. Total consideration to acquire the assets and the territory was $400,000 in cash and $40,000 through the issuance of 160,000 Inner Spirit common shares at a price of $0.25. The location will be converted and opened as a wholly-owned corporate Spirit Leaf location in Jasper.

| | | |
|---|---|---|
| Furniture and fixtures | $ | 126,007 |
| Store permit | | 313,993 |
| Assets acquired | $ | **440,000** |
| Consideration paid | | |
| Cash | $ | 400,000 |
| 160,000 Common Shares (Note 15(b)(xiv) | | 40,000 |
| Total consideration | $ | **440,000** |

The purchase of these furniture and fixtures and provisionally approved recreational cannabis dispensary permits was accounted for as asset acquisitions as the transactions did not meet the definition of a business combination.

## 7. PROPERTY AND EQUIPMENT

| Cost | Computer Equipment | Furniture and Fixtures | Vehicle | Leasehold Investments | Total |
|---|---|---|---|---|---|
| Beginning, March 16, 2017 | $ - | $ - | $ - | $ - | $ - |
| Acquired in business combination (Note 6(i)) | 8,471 | 274,860 | - | 815,241 | 1,098,572 |
| Additions | 6,147 | 2,671 | - | - | 8,818 |
| December 31, 2017 | $ 14,618 | $ 277,531 | $ - | $ 815,241 | $ 1,107,390 |
| **Additions** | **53,146** | **486,781** | **27,557** | **921,343** | **1,488,827** |
| **December 31, 2018** | **$ 67,764** | **$ 764,312** | **$ 27,557** | **$ 1,736,584** | **$ 2,596,217** |
| Accumulated depreciation | | | | | |
| Beginning, March 16, 2017 | $ - | $ - | $ - | $ - | $ - |
| Depreciation for the period | (5,516) | (25,708) | - | (75,020) | (106,244) |
| December 31, 2017 | $ (5,516) | $ (25,708) | $ - | $ (75,020) | $ (106,244) |
| **Depreciation for the year** | **(19,827)** | **(131,539)** | **(4,134)** | **(491,357)** | **(646,857)** |
| **Impairment (Note 8)** | **(3,212)** | **(167,357)** | **-** | **(323,331)** | **(493,900)** |
| **December 31, 2018** | **$ (28,555)** | **$ (324,604)** | **$ (4,134)** | **$ (889,708)** | **$ (1,247,001)** |
| **Net book value** | | | | | |
| December 31, 2017 | $ 9,102 | $ 251,823 | $ - | $ 740,221 | $ 1,001,146 |
| **December 31, 2018** | **$ 39,209** | **$ 439,708** | **$ 23,423** | **$ 846,876** | **$ 1,349,216** |

With regard to the Watch It! retail CGU's, the Company concluded that there were indicators of impairment as at December 31, 2018, and an impairment test was performed. As a result of the impairment test, as outlined in Note 8, certain property and equipment assets related to the impaired CGU's were written down.

## 8. GOODWILL AND INTANGIBLE ASSETS

| Cost | Goodwill | Franchise Agreement | Trademarks | Store Permits | Total |
|---|---|---|---|---|---|
| Beginning, March 16, 2017 | $ - | $ - | $ - | $ - | $ - |
| Acquired in business combination (Note 6) | 2,078,018 | 500,000 | 530,000 | - | 3,108,018 |
| December 31, 2017 | $ 2,078,018 | $ 500,000 | $ 530,000 | $ - | $ 3,108,018 |
| **Acquired during the year (Note 6)** | **-** | **-** | **-** | **713,993** | **713,993** |
| **December 31, 2018** | **$ 2,078,018** | **$ 500,000** | **$ 530,000** | **$ 713,993** | **$ 3,822,011** |
| | | | | | |
| **Accumulated amortization** | | | | | |
| Beginning, March 16, 2017 | $ - | $ - | $ - | $ - | $ - |
| Amortization for the period | - | (25,000) | - | - | (25,000) |
| December 31, 2017 | $ - | $ (25,000) | $ - | $ - | $ (25,000) |
| **Amortization for the year** | **-** | **(50,000)** | **-** | **-** | **(50,000)** |
| **Impairment** | **(2,078,018)** | **(425,000)** | **(530,000)** | **-** | **(3,033,018)** |
| **December 31, 2018** | **$ (2,078,018)** | **$ (500,000)** | **$ (530,000)** | **$ -** | **$ (3,108,018)** |
| | | | | | |
| **Net book value** | | | | | |
| December 31, 2017 | $ 2,078,018 | $ 475,000 | $ 530,000 | $ - | $ 3,083,018 |
| **December 31, 2018** | **$ -** | **$ -** | **$ -** | **$ 713,993** | **$ 713,993** |

During 2018, management assessed whether indicators of impairment existed and concluded indicators of impairment existed on the Watch It! CGU's, as a result of continuing losses and therefore an impairment test was performed. As a result, the Company recorded a $3,526,918 impairment charge allocated to property and equipment of $493,900, intangible asset of $955,000, and goodwill of $2,078,018 relating to the Watch it! CGU's.

The recoverable amount of the Watch it! CGU's was determined based on an adjusted net asset method which is an acceptable method under the fair value less cost of disposal methodology ("FVLCD"). Due to the cash flow forecasts projecting continuing negative cash flows, there is no basis for which to prepare an income approach to calculate the recoverable amount of the CGU's under the value-in-use methodology. A change of 10% to the assumptions used would not result in a change to the amount of impairment recorded.

## 9. ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

| As at December 31, | | 2018 | | 2017 |
|---|---|---|---|---|
| Accounts payable and accrued labilities | **$** | **1,294,261** | $ | 537,401 |
| Good and Services/Harmonized/Provincial Sales tax payable | | **-** | | 2,373 |
| | **$** | **1,294,261** | $ | 539,774 |

## 10. UNREDEEMED GIFT CARD LIABILITY

The Company has outstanding $183,531 (2017 - $76,472) of unredeemed gift card liabilities that have been purchased by customers for use at it's Watch It stores.

## 11. RELATED PARTY TRANSACTIONS

### Key management and director compensation

The Company's key management personnel have authority and responsibility for overseeing, planning, directing and controlling the activities of the Company. Key management personnel include members of the Board of Directors, and executive officers. Compensation of key management personnel may include short-term and long-term benefits. Short-term benefits include salaries and consulting fees. Long-term benefits include stock options. Compensation provided to current key management are as follows:

| | | Year ended December 31, 2018 | | Period from incorporation on March 16 to December 31, 2017 |
|---|---|---|---|---|
| Short-term benefits | **$** | **364,100** | $ | 165,000 |
| Long-term benefits (*) | | **61,171** | | - |
| | **$** | **425,271** | $ | 165,000 |

(*) Consists of share-based payments as the fair value of options granted to key management personnel of the Company under the Company's stock option plan

As at December 31, 2018, there was $100,000 (2017 - $5,000) of outstanding payables to related parties, that is included in accounts payable and accrued liabilities.

During the year ended December 31, 2018, the Company paid rent for office space to a company related by virtue of a common officer and director, in the amount of $43,796 (period from March 16 to December 31, 2017 - $30,565). Subsequent to year end, the Company entered into a new lease agreement effective March 1, 2019 for a term of 5 years, for $30,000 per year for the first 3 years, and $32,070 per year for the last 2 years. The yearly rent was based on a fair value assessment completed by an independent appraiser.

As at December 31, 2017, payable to related party was an interest-bearing promissory note secured over all the property of the Watch It! and due on demand which bore interest at a rate per annum of 12.5%, compounded monthly. The loan was secured by all the property of the Watch It! , pari-passu to the Royalty Agreement (Note 13). During the year ended December 31, 2018, the payable to related party was paid out in full (2017 - $593,141). There was $10,875 in interest expense to the officer during the year ended December 31, 2018 (2017 - $36,330) in relation to this note.

As at December 31, 2018, payable to related party was a non-interest-bearing, unsecured, due on demand loan of $208,779 (2017- $nil) for costs incurred for Spirit Leaf Macleod.

## 12. FRANCHISE FEE DEPOSITS

The Company has a franchise model associated with its cannabis operations. The Company charges a franchise fee of $25,000 for the first location and $12,500 for each additional location. For franchise agreements entered into before June 30, 2018, the franchisee was required to pay as follows: (i) $15,000 upon signing the franchise agreement (2017 - $5,000 upon signing the agreement and $10,000 by December 31, 2017) and (ii) $10,000 by June 30, 2018. The franchisee was required to pay for each additional location as follows (i) $8,750 upon signing the Franchise Agreement and (ii) $3,750 by June 30, 2018. For Franchise Agreements entered into after June 30, 2018, the entire fee was due upon signing. For those franchisees that signed agreements in 2017, the franchisee was able to invest a portion of the franchise fee into common shares of the Company.

### Non-Refundable

Franchise Agreements dated before September 30, 2018 provided that $5,000 of the franchise fee was non-refundable. Franchise Agreements dated after September 30, 2018 provide that $10,000 of the franchise fee is non-refundable.

### Refundable

The remaining $15,000 initial deposit is non-refundable, unless a lease is not signed by the Landlord and the Franchisee and delivered to the Company by June 30, 2019. At the option of the Company they may terminate the lease agreement and any refundable initial fee less amounts payable to the Company shall be refundable. The refundable portion of the franchise fees are deposited into a savings bank account, which is segregated from the Company's operating bank accounts. These are classified as long term as repayment is at the option of the Company.

As at December 31 2018, this amount is accounted for as a non-current liability, except for the initial fees expected to be earned or refunded within the next 12 months.

| | | Non-Refundable | | Refundable | | Total |
|---|---|---|---|---|---|---|
| Balance as of December 31, 2017 | **$** | 460,100 | $ | - | $ | 460,100 |
| New franchises | | 278,750 | | 1,336,250 | | 1,274,750 |
| Terminated franchises | | (40,000) | | (103,750) | | (143,750) |
| Franchise fees recognized | | (88,750) | | - | | (88,750) |
| Balance as at December 31, 2018 | $ | **610,100** | **$** | **1,232,500** | **$** | **1,502,350** |
| Current portion | | 53,750 | | - | | 53,750 |
| Long term portion | $ | 556,350 | $ | 1,232,500 | $ | 1,788,850 |

As at December 31, 2018, there was an aggregate of $340,250 (2017- $nil) owing on the last payment by the franchisees. As the Company has the unconditional right to payment it has been included in franchise fee deposits.

## 13. ROYALTY DEBT

As at December 31, 2018, royalty debt was $nil (2017 - $1,000,000). On January 18, 2018, the Royalty Agreement was terminated and the royalty owing thereunder was converted to 10,000,000 common shares at a deemed price of $0.10 per share (Note 15(b)(v)). Prior thereto, the Company received financing from Grenville Strategic Royalty Corp. ("Grenville") in the form of a secured royalty agreement in the amount of $1,000,000 in exchange for a royalty on gross sales in perpetuity (the "Royalty Agreement"). The agreement required the Company to make minimum monthly royalty payments of no less than $10,417 per month or a monthly royalty payment equal to 0.40% of system wide sales. For the year ended December 31, 2018, the Company recorded total royalty expense of $5,040 (2017 - $58,132).

## 14. COMMITMENTS

### Leases

The Company leases several retail outlets under operating leases expiring between 2018 and 2028, some of which are subleased for the full amount of the lease payments and some of which are used for the operations of its corporate stores. The Company also guarantees leases for several franchised retail outlets. If the franchisees defaulted on the lease payments, the Company would be liable for these lease payments and the ongoing lease liability. All of the Company's leases for Spirit Leaf have a conditional termination clause that allows for the lease to be terminated with a pre-determined penalty in the event that the Company is not able to secure a permit to sell cannabis at any particular location.

The Company has entered into and provided a covenant for various non-cancellable operating lease agreements. These lease agreements expire between December 31, 2019 and May 31, 2028.

As at December 31, 2018, the minimum annual lease payments for corporately operated locations are expected to be as follows:

| | Watch It! | Spirit Leaf |
|---|---|---|
| 2019 | $ 520,900 | $ 1,611,301 |
| 2020 | $ 412,589 | $ 1,613,685 |
| 2021 | $ 137,654 | $ 1,622,089 |
| 2022 | $ 16,981 | $ 1,646,614 |
| 2023 | $ - | $ 1,559,218 |
| Thereafter | $ - | $ 3,353,145 |

As at December 31, 2018, the minimum annual lease payments for franchise operated locations where the Company or its subsidiaries either sub-leased, assigned or provided a covenant for its franchisees are expected to be as follows. Payments are made directly to the landlord and the lease payment would only revert to the Company if a franchisee defaulted on their obligations under the terms of the sub-lease or lease.

| | Watch It! | Spirit Leaf |
|---|---|---|
| 2019 | $ 553,224 | $ 1,120,438 |
| 2020 | $ 514,109 | $ 1,120,438 |
| 2021 | $ 477,703 | $ 1,139,535 |
| 2022 | $ 439,640 | $ 1,148,092 |
| 2023 | $ 319,740 | $ 1,102,336 |
| Thereafter | $ 583,980 | $ 787,600 |

## 15. SHARE CAPITAL

### (a) Authorized:

The Company is authorized to issue an unlimited number of common shares and preferred shares with no par value.

### (b) Issued common shares:

| | Note | Number | | Amount |
|---|---|---|---|---|
| Balance at March 16, 2017 | | - | $ | - |
| Founder shares and private placements | (i) | 37,100,589 | | 931,439 |
| Watch it! business combination (Note 6(i)) | (ii) | 27,345,516 | | 2,485,956 |
| Amalgamation with 2043246 Alberta Ltd. (Note 6(ii)) | (iii) | 1,500,000 | | 45,000 |
| Share issuance costs | | - | | (41,524) |
| Balance, December 31, 2017 | | 65,946,105 | $ | 3,420,871 |
| **Private placements** | (iv,viii) | 23,553,895 | | **2,355,390** |
| **Debt conversion (Note 13)** | (v) | 10,000,000 | | **1,000,000** |
| **Initial public offering** | (xi) | 25,000,000 | | **2,974,320** |
| **Corporate investments** | (vi, vii, ix, x, xii, xiii, xv) | 59,776,190 | | **7,513,093** |
| **Franchisee acquisitions** | (xiv) | 1,593,334 | | **465,000** |
| **Warrant exercise** | (xvi) | 250,000 | | **37,500** |
| **Option exercise** | (xvii) | 60,000 | | **11,032** |
| **Share issuance costs** | | - | | **(805,546)** |
| **Balance, December 31, 2018** | | **186,179,524** | $ | **16,971,660** |

Pursuant to the amalgamation on August 31, 2017, shareholders of the Company received 11 common shares in exchange for every 1 of their prior common shares. All numbers reflect the post-split shares.

i. During the year ended December 31, 2017, the Company issued founder shares and completed several private placements.
   - On March 16, 2017, the Company issued 14,300,000 Common shares to founders at a price of $0.001 for gross proceeds of $13,000.
   - On May 4, 2017, the Company issued 12,912,889 Common shares to key employees and consultants at a price of $0.001 for gross proceeds of $11,739.
   - On May 11, 2017, the Company completed a private placement by issuing 6,820,000 Common shares at a price of $0.10 for gross proceeds of $620,000.
   - On June 30, 2017, the Company completed a private placement by issuing 2,141,700 Common shares at a price of $0.10 for gross proceeds of $194,700.
   - On July 5, 2017, the Company the Company completed a private placement by issuing 66,000 Common shares at a price of $0.10 for gross proceeds of $6,000.
   - On September 15, 2017, the Company completed a private placement by issuing 860,000 Common shares at a price of $0.10 for gross proceeds of $86,000.

ii. On July 15, 2017, the Company acquired Watch It! by issuing 27,345,516 Common shares at a price of $0.0909 for gross consideration of $2,485,956.

iii. On August 31,2017, the Company amalgamated with 204AB., and issued 1,500,000 Common shares at a price of $0.03 per share with a cost of $45,000.

iv. On January 18, 2018, and February 5, 2018, the Company completed a private placement by issuing 17,553,895 Common shares at a price of $0.10 per share for gross proceeds of $1,755,390. Of these total proceeds, $1,149,556 was received prior to year-end and was recorded as share subscriptions.

## 15. SHARE CAPITAL (CONTINUED)

v. On January 18, 2018, the Company issued 10,000,000 Common shares at a price of $0.10 to Grenville pursuant to the termination of the Royalty Agreement.

vi. On February 6, 2018, the Company issued 15,000,000 Common shares to Auxly at a price of $0.10 per share as part of the investment agreement entered into with Auxly (Note 4(i)).

vii. On February 6, 2018 and March 27, 2018, the Company issued a total of 2,558,824 Common shares to Auxly at $0.10 per share for cash consideration of $255,882 pursuant to the Auxly Anti-Dilution Right (Note 4(i)).

viii. On March 27, 2018, the Company completed a private placement by issuing 6,000,000 Common shares at a price of $0.10 for gross proceeds of $600,000.

ix. On June 22, 2018, the Company issued 7,500,0000 units at a price of $0.15 per unit to Sugarbud Craft Growers Corp. for $1,125,000 in cash. Each unit consists of one common share and one-half common share purchase warrant exercisable at $0.30 per share until June 22, 2020, which was valued at $237,227 (Note 15(e)).

x. On June 22, 2018, pursuant to the exercise of the Auxly Anti-Dilution Right (Note 5(i)), the Company issued 1,323,529 units at a price of $0.15 per unit for cash consideration of $198,529. Each unit consists of one common share and one-half common share purchase warrant exercisable at $0.30 per share until June 22, 2020, which was valued at $41,864 (Note 15(e)).

xi. On July 31, 2018, the Company completed its initial public offering (“IPO”) raising $3,750,000 through the issuance of 25,000,000 units, at a price of $0.15 per unit. Each unit consists of one common share in the capital of the Company and one-half of one common share purchase exercisable at $0.30 per share until July 31 2020, which was valued at $775,680 (Note 15(e)).

xii. On July 31, 2018 the Company issued Newstrike 15,000,000 units of the Company with a fair value of $2,087,958 as part of their investment agreement (Note 4(ii)). Each unit consists of one common share of the Company and one-half of a common share purchase warrant, exercisable at $0.30 per share until July 31, 2020, which was valued at $465,408 (Note 15(e)).

xiii. On July 31, 2018, , the Company issued 4,411,765 units and 2,647,059 units pursuant to the exercise of the Auxly Anti-Dilution right (Note 4(i)) at a price of $0.15 per unit, for gross proceeds of $1,058,823. Each unit consists of one common share of the Company and one-half of a common share purchase warrant, exercisable at $0.30 per share until July 31, 2020, which was valued at $218,602 (Note 15(e)).

xiv. On September 24, 2018, and October 26, 2018 the Company, issued 1,333,334 and 160,000 Common shares, at a price of $0.30 and 0.25 per share, respectively for the purchase of two of the Spirit Leaf stores (Note 6(iii,iv)). The Company also issued 100,000 common shares to its Jasper franchise partner to terminate their franchise agreement at a price of 0.25 per share.

xv. On December 10, 2018 the Company issued 11,335,013 common shares of Inner Spirit at a price of $0.20 per share for gross proceeds of $2,250,000 pursuant to an investment agreement with Tilray, Inc.

xvi. During the year ended December 31, 2018, a total of 250,000 shares were issued based on warrant exercises at a price of $0.10 per share. The fair value of these warrants of $12,500, was transferred from contributed surplus to share capital.

xvii. During the year ended December 31, 2018, a total of 60,000 shares were issued based on option exercises at a price of $0.10 per share. The fair value of these warrants of $5,032 was transferred from contributed surplus to share capital.

## 15. SHARE CAPITAL (CONTINUED)

### (c) Shares held in escrow

In conjunction with the Company's IPO, an aggregate of 38,143,853 Common shares were deposited in escrow pursuant to applicable securities law, to be released as follows based on the following terms:

a. 10% on the date the Company's securities are listed on a Canadian exchange;
b. 15% - 6 months following the listing date;
c. 15% - 12 months following listing date;
d. 15% - 18 months following the listing date;
e. 15% - 24 months following the listing date;
f. 15%- 30 months following the listing date; and,
g. 15% -36 months following the listing date.

As at December 31, 2018, 3,814,385 Common shares had been released.

### (d) Options

The board of directors of the Company may from time to time, in its discretion, grant to directors, officers, employees and consultants of the Company, non-transferable options to purchase common shares provided that the number of common shares reserved for issuance under all outstanding options will not exceed 10% of the issued and outstanding common shares.

As at December 31, 2018, the following options are outstanding.

| | Number of Options | Weighted Average Exercise Price ($) |
|---|---|---|
| Balance, December 31, 2017 | - | - |
| Issued during year | 14,725,000 | 0.14 |
| Exercised during year (Note 15(b)(xvii)) | (60,000) | 0.10 |
| Forfeited during year | (80,000) | 0.10 |
| Balance, December 31, 2018 | 14,585,000 | 0.14 |
| **Exercisable, end of year** | 3,541,250 | 0.14 |

i) On February 28, 2018, the Company granted 9,125,000 options at a price of $0.10 per share to directors, officers, employees, and consultants, pursuant to the Company's stock option plan. One fourth of the stock options vest immediately and the remaining stock options granted vest one fourth on each of the first, second, and third anniversary of the grant date. The forfeiture rates are based on historical data and managements estimates. The fair value of the options granted is estimated as at the grant date using the Black-Scholes option pricing model. The following assumptions were used in the Black Scholes model (a) risk free interest rate of 1.94%, (b) share price volatility of 123%, (c) forfeiture rate 0.88%, and (d) 5 years as expected life of options.

ii) On December 10, 2018, the Company granted 5,600,000 options at a price of $0.20 per share to directors, officers, employees, and consultants, pursuant to the Company's stock option plan. One fourth of the stock options vest immediately and the remaining stock options granted vest one fourth on each of the first, second, and third anniversary of the grant date. The forfeiture rates are based on historical data and managements estimates. The fair value of the options granted is estimated as at the grant date using the Black-Scholes option pricing model. The following assumptions were used in the Black Scholes model (a) risk free interest rate of 1.93%, (b) share price volatility of 109%, (c) forfeiture rate 0.88%, and (c) 5 years as expected life of options.

Share-based compensation recognized on the issuance of the above options during the year ended December 31, 2018 was $730,169 (2017 - $nil).

## 15. SHARE CAPITAL (CONTINUED)

### (d) Options (continued)

| Options Outstanding | Weighted Average Exercise Price ($) | Weighted Average Remaining Term (Years) | Options Exercisable | Weighted Average Exercise Price ($) |
|---|---|---|---|---|
| 8,985,000 | 0.10 | 4.16 | 2,141,250 | 0.10 |
| 5,600,000 | 0.20 | 4.95 | 1,400,000 | 0.20 |
| 14,585,000 | 0.14 | 4.56 | 3,541,250 | 0.14 |

Subsequent to December 31, 2018, 140,000 options were exercised at a price of $0.10 per share.

### (e) Warrants

During the year ended December 31, 2018, the Company issued warrants for consulting services, security for leases, investments, and the initial public offering. The value of the warrants was calculated by using the Black Scholes Model. The following assumptions were used in the Black Scholes model (a) risk free interest rate of 1.77% to 2.18% (b) share price volatility of 76%-110%, and (c) 1.5-5 year expected life of warrants. Share-based compensation recognized on the warrants issued for service and investor relations is $113,694.

| | Number of Warrants | Amount ($) | Weighted Average Exercise Price ($) | Weighted Average Expiry Date (Years) |
|---|---|---|---|---|
| Balance, December 31, 2017 | - | - | - | - |
| Issued for services | 2,250,000 | 107,674 | 0.13 | 2.38 |
| Sugarbud investment (Note 14(ix)) | 3,750,000 | 237,227 | 0.30 | 1.48 |
| Auxly investment (Note 14(x)) | 661,765 | 41,864 | 0.30 | 1.48 |
| IPO warrants (Note 14 (xi)) | 12,500,000 | 775,680 | 0.30 | 1.59 |
| Agents broker warrants | 2,500,000 | 213,334 | 0.30 | 1.59 |
| Auxly investment (Note 14 (xiii)) | 3,529,412 | 218,602 | 0.30 | 1.59 |
| Newstrike investment (Note 14 (xii)) | 7,500,000 | 465,408 | 0.30 | 1.59 |
| Cancellation of franchise agreement | 360,500 | 79,144 | 0.28 | 1.66 |
| Investor relation warrants | 100,000 | 6,020 | 0.30 | 1.56 |
| Exercised (Note 15 (xvi)) | (250,000) | (12,500) | 0.10 | - |
| Warrant issue costs | - | (183,652) | - | - |
| Balance, December 31, 2018 | 32,901,677 | 1,948,801 | 0.29 | 1.63 |
| Exercisable, end of year | 32,101,677 | | 0.30 | 1.57 |

## 16. NET LOSS PER COMMON SHARES

The calculation of basic and diluted loss per share for the year ended December 31, 2018 was based on the loss attributable to common shareholders of $11,688,327 (2017 - $1,398,182) and the weighted average number of common shares outstanding of 137,469,525 (2017 - 38,786,809). The shares held in escrow have been included in the calculation as they are released based over a set period of time.

## 17. NON-CONTROLLING INTEREST

As a December 31, 2018, Inner Spirit owned 50.1% of Spirit Leaf Macleod Inc. and 1010805 Alberta Ltd. (“Numberco”) owned a 49.9% non-controlling interest and holds 49.9% of the voting rights.

Inner Spirit and Numberco entered into a memorandum of understanding (“MOU”). The intention of the MOU is to set forth a general business agreement in connection with the establishment and operation of a Spiritleaf franchise cannabis dispensary (the “Business”). The parties will contribute pro rata to the costs incurred and profit generated from the Business. During 2018, Numberco was issued 499 Class B Common shares on Spirit Leaf Macleod Inc; giving it control over 49.9% of the outstanding voting shares.

| | **Numberco NCI Ownership** |
|---|---|
| Spirit Leaf Macleod Inc. | 49.9% |
| | **Spirit Leaf Macleod Inc. as of December 31, 2018** |
| Net loss and comprehensive loss | $ (13,319) |
| Total loss and comprehensive loss attributable to NCI | (6,646) |
| **Acquisition of share by NCI** | (39,472) |
| **Total non-controlling interest** | **(46,118)** |
| Current assets | 26,768 |
| Non-current assets | 398,012 |
| Current liabilities | (230,445) |
| Non-current liabilities | (309,378) |
| **Net assets** | **(115,043)** |
| Cash flows used in operating activities | (88,664) |
| Cash flows provided by financing activities | 541,889 |
| Cash flows used in investing activities | (426,457) |
| **Net increase in cash** | **$ 26,768** |

## 18. MOVEMENTS IN NON-CASH WORKING CAPITAL

| For the years ended December 31, | **Year ended December 31, 2018** | Period ended from incorporation on March 16 to December 31, 2017 |
|---|---|---|
| Accounts receivables | **$(491,741)** | $(87,101) |
| Prepaid expenses and deposits | **(116,362)** | (57,365) |
| Inventory | **(2,028,556)** | 191,275 |
| Lease deposits | **(1,118,639)** | (8,000) |
| Accounts payables and accrued liabilities | **754,487** | 46,769 |
| Unredeemed gift card liability | **107,059** | 6,701 |
| Franchise fee deposits | **1,382,500** | 460,100 |
| | **$(1,511,252)** | $552,379 |

## 19. INCOME TAXES

The Company does not have any current income tax expense. The following table reconciles the expected income tax recovery at the statutory income tax rate to the expense in the statement of loss and comprehensive loss:

| | | 2018 | | 2017 |
|---|---|---|---|---|
| Net loss before income taxes | **$** | **(11,694,973)** | $ | (1,398,682) |
| Statutory income tax rate | | **27%** | | 27% |
| Expected income tax recovery | | **(3,157,643)** | | (377,644) |
| Permanent differences | | **939,862** | | - |
| Share issue costs and other | | **(670,030)** | | (11,183) |
| Rate differential | | **282,532** | | - |
| Tax benefit not recognized | | **2,605,279** | | 325,327 |
| **Income tax recovery** | **$** | **-** | $ | (63,500) |

Details of the unrecognized deductible differences are as follows:

| | | 2018 | | 2017 |
|---|---|---|---|---|
| Deferred tax liabilities: | | | | |
| Property and equipment | **$** | **-** | $ | 5,112 |
| Store permits | | **4,819** | | |
| Trademarks | | **-** | | 6,035 |
| Franchises | | **-** | | 6,372 |
| Goodwill | | **-** | | 58,110 |
| | | **4,819** | | 75,629 |
| Deferred tax assets: | | | | |
| Non-capital losses available for future periods | | **(4,819)** | | (75,629) |
| **Deferred taxes** | **$** | **-** | $ | - |

| | | 2018 | | 2017 |
|---|---|---|---|---|
| **Deferred tax assets not recognized** | | | | |
| Non-capital losses available for future periods | | **6,357,374** | | 1,171,651 |
| Share issuance costs | | **816,273** | | 33,219 |
| Marketable securities | | **2,092,828** | | |
| Goodwill and intangibles | | **1,734,725** | | - |
| Property and equipment | | **895,848** | | - |
| Total deductible differences | **$** | **11,897,048** | $ | 1,204,870 |

The deferred tax asset has not been recognized in respect of these items because it is not probable that future taxable profit will be available against which the Company can utilize benefits.

The Company's Canadian non-capital tax losses carried forward will begin to expire in 2039.

## 20. SEGMENTED INFORMATION

The Company is a holding company that operates in three segments through its four subsidiaries, (i) Spirit Leaf Inc. Spirit Leaf Corporate Inc., and Spirit Leaf Macleod Inc., which have the primary business of the sale of cannabis and accessories through retail outlets, and the sale and on-going support of franchise cannabis dispensaries across Canada; (ii) Watch It! Consolidated Ltd., which has the primary business of on-going support of retail watch store franchises and the sale of watches and accessories through retail outlets across Canada and website sales, and (iii) Inner Spirit, a division for its corporate administration. All of the Company's assets are located in Canada.

| Year ended December 31, 2018 | Watch It! ($) | Spirit Leaf ($) | Inner Spirit ($) | NCI ($) | Total ($) |
|---|---|---|---|---|---|
| **Revenue** | | | | | |
| Retail revenue | 4,949,661 | 20,860 | - | - | 4,970,521 |
| Royalties | 159,616 | 45,732 | - | - | 205,348 |
| Advertising | 45,197 | 9,147 | - | - | 54,344 |
| Millwork | - | 376,369 | - | - | 376,369 |
| Franchise fees | - | 88,750 | - | - | 88,750 |
| Supply revenue and other | 12,695 | 83,358 | - | - | 96,053 |
| | 5,167,169 | 624,216 | - | - | 5,791,385 |
| **Cost of goods sold** | 2,731,974 | 434,097 | - | - | 3,166,071 |
| **Gross profit** | 2,435,195 | 190,119 | - | - | 2,625,314 |
| General and administrative | 352,941 | 963,451 | 885,293 | 108 | 2,201,793 |
| Salaries, wages, and benefits | 1,654,488 | 1,161,427 | 101,221 | - | 2,917,136 |
| Occupancy costs | 925,385 | 578,362 | - | 77 | 1,503,824 |
| Depreciation and amortization | 552,430 | 137,914 | 52 | 6,461 | 696,857 |
| Sales and marketing | 96,497 | 338,309 | 92,232 | - | 527,038 |
| Total operating expenses | 3,581,741 | 3,179,463 | 1,078,798 | 6,646 | 7,846,648 |
| **Operating loss before other expenses** | (1,146,546) | (2,989,344) | (1,078,798) | (6,646) | (5,221,334) |
| Share-based compensation | - | - | 843,863 | | 843,863 |
| Unrealized loss on marketable securities | - | - | 2,092,828 | - | 2,092,828 |
| Impairment loss | 3,526,918 | - | - | - | 3,526,918 |
| Interest | 11,161 | (2,478) | (3,693) | - | 4,990 |
| Royalties | 5,040 | - | - | - | 5,040 |
| **Net loss and comprehensive loss** | 4,689,665 | (2,986,866) | (4,011,796) | (6,646) | (11,694,973) |
| | | | | | |
| **Total assets** | 1,317,949 | 6,924,608 | 3,207,112 | - | 11,449,669 |
| **Total liabilities** | 590,776 | 2,736,800 | 1,506,650 | - | 4,834,226 |

## 20. SEGMENTED INFORMATION (CONTINUED)

| Ten months ended December 31, 2017 | | Watch It! ($) | Spirit Leaf ($) | Inner Spirit ($) | Total ($) |
|---|---|---|---|---|---|
| **Revenue** | | | | | |
| Retail revenue | $ | 2,760,613 | - | - | 2,760,613 |
| Royalties | | 110,606 | - | - | 110,606 |
| Advertising | | 29,963 | - | - | 29,963 |
| Miscellaneous revenue | | 9,944 | 1,146 | - | 11,090 |
| | | 2,911,126 | 1,146 | - | 2,912,272 |
| **Cost of goods sold** | | 1,518,595 | - | - | 1,518,595 |
| **Gross profit** | | 1,392,531 | 1,146 | - | 1,393,677 |
| General and administrative | | 157,842 | 126,332 | 481,727 | 765,901 |
| Salaries, wages, and benefits | | 923,889 | - | 130,000 | 1,053,889 |
| Occupancy costs | | 451,276 | - | - | 451,276 |
| Depreciation and amortization | | 127,351 | 3,381 | 512 | 131,244 |
| Sales and marketing | | 60,726 | 85,215 | 149,543 | 295,484 |
| Total expenses | | 1,721,084 | 214,928 | 761,782 | 2,697,794 |
| **Operating loss before other expenses** | | 328,553 | 213,782 | 761,782 | 1,304,117 |
| Interest | | 36,433 | - | - | 36,433 |
| Royalties | | 58,132 | - | - | 58,132 |
| **Loss before income taxes** | $ | 423,118 | 213,782 | 761,782 | 1,398,682 |
| **Recovery of deferred taxes** | | (63,500) | - | - | (63,500) |
| **Loss and comprehensive loss** | | 359,618 | 213,782 | 761,782 | 1,335,182 |
| | | | | | |
| **Total assets** | $ | 4,955,671 | 278,987 | 670,074 | 5,904,732 |
| **Total liabilities** | $ | 2,129,284 | 481,920 | 58,283 | 2,669,487 |

## 21. CAPITAL RISK MANAGEMENT

The Company’s objectives when managing its capital are to safeguard its ability to continue as a going concern, to meet its capital expenditures for its continued operations, and to maintain a flexible capital structure which optimizes the cost of capital within a framework of acceptable risk. The Company manages the capital structure and makes adjustments to it in light of changes in economic conditions and the risk characteristics of the underlying assets. To maintain or adjust its capital structure, the Company may issue new shares, issue new debt, or acquire or dispose of assets. The Company is not subject to externally imposed capital requirements.

Management reviews its capital management approach on an ongoing basis and believes that this approach, given the relative size of the Company, is reasonable. There have been no changes to the Company’s capital management approach in the year. The Company considers its shareholders’ equity as capital which, as at December 31, 2018, is $6,661,561 (2017 - $3,235,245).

## 22. FINANCIAL INSTRUMENTS AND RISK FACTORS

### Fair values

At December 31, 2018, the Company's financial instruments consist of cash, short-term deposits, accounts receivable, marketable securities, accounts payable and accrued liabilities, payable to shareholder, and royalty debt. The fair values of cash, short-term deposits, accounts receivable, and accounts payable and accrued liabilities approximate their carrying values due to the relatively short-term maturity of these instruments. Marketable securities have been marked to market. The fair value of the payable to shareholder and royalty debt are estimated using a discount cashflow valuation technique.

## 22. FINANCIAL INSTRUMENTS AND RISK FACTORS (CONTINUED)

### Fair value hierarchy

Financial instruments recorded at fair value are classified using a fair value hierarchy that reflects the significance of the inputs used in making the measurements. The fair value hierarchy has the following levels:

- Level 1 - valuation based on quoted prices (unadjusted) in active markets for identical assets or liabilities.
- Level 2 - valuation techniques based on inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices).
- Level 3 - valuation techniques using inputs for the asset or liability that are not based on observable market data (unobservable inputs).

The fair value hierarchy requires the use of observable market inputs whenever such inputs exist. A financial instrument is classified to the lowest level of the hierarchy for which a significant input has been considered in measuring fair value.

Marketable securities are classified as level 1, and the warrants included in marketable securities are classified as level 2. During the years ended December 31, 2018 and 2017, there were no transfers of amounts between levels.

The Company has exposure to the following risks from its use of financial instruments:

- Credit risk;
- Liquidity risk; and,
- Market risk.

### Credit risk

Credit risk is the risk of loss associated with the counterparty's inability to fulfil its payment obligations. Financial instruments that potentially subject the Company to concentrations of credit risks consist principally of cash, short term deposits and accounts receivable. All of the Company's cash includes petty cash, store cash floats, and cash held at a financial institution which is a Canadian Chartered in which management believes that the risk of loss is minimal. The accounts receivable balances consist of an ongoing account held with PayPal, Spirit Leaf franchise fee deposits outstanding, royalty revenue receivable from the franchises from the previous month, and receivable from franchise for millwork, which are considered reputable companies.

| As at December 31, | | **2018** | | 2017 |
|---|---|---|---|---|
| Current | **$** | **46,770** | $ | 87,101 |
| 31 – 60 days | | **83,905** | | - |
| 61 – 90 days | | **25,970** | | - |
| Greater than 90 days | | **422,197** | | - |
| Accounts receivable | **$** | **578,842** | $ | 87,101 |

For the year-ended December 31, 2018, the total revenue included in accounts receivable is $25,413 (2017- $50,217).

The Company assessed the credit loss risk to be nominal. The maximum credit risk exposure associated with cash, short-term deposits and accounts receivable is the total carrying value.

## 22. FINANCIAL INSTRUMENTS AND RISK FACTORS (CONTINUED)

### Liquidity risk

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they fall due. The Company currently settles its financial obligations with cash. As at December 31, 2018, the Company's financial liabilities consist of accounts payable and accrued liabilities, which have contractual maturity dates within one year. As the Company has historically provided refundable franchise fee deposits, these deposits may become financial obligations at the discretion of the Company. The Company manages its liquidity risk by reviewing its capital requirements on an ongoing basis. There have been no changes in the Company's strategy with respect to credit/liquidity risk in the year. All financial liabilities are due within a year.

| As at December 31, | Maturity | | 2018 |
|---|---|---|---|
| Accounts payables and accrued liabilities | Within 1 year | $ | 1,294,261 |
| Advances from related party | Within 1 year | | 208,779 |
| Refundable franchise fee deposits | Within 1 year | | 53,750 |
| | | $ | 1,556,790 |

### Market risk

Market risk is the risk that changes in market prices will affect the Company's earnings or the value of its financial instruments. The objective of market risk management is to manage and control exposures within acceptable limits, while maximizing returns. The Company is exposed to equity price risk, which arises from investments measured at fair value through profit or loss ("FVTPL"). For investments classified as FVTPL, the impact of a 10% increase in the share price would have increased equity by $119,911 net tax. An equal change in the opposite direction would have decreased equity by $119,911 net tax.

## 23. SUBSEQUENT EVENTS

i) Subsequent to the year ended December 31, 2018, the Company announced that through its wholly owned subsidiary Spirit Leaf Corporate Inc., it has entered into an agreement with a Spirit Leaf franchise partner to purchase the assets of three proposed cannabis retail stores. Total consideration payable for the locations was $2,000,000, of which $1,500,000 was paid through the issuance of 7,075,472 common shares of Inner Spirit at a issue price equal to $0.212 per share, as well as $250,000 in cash and a $250,000 promissory note due one year after the closing of the acquisition.

ii) On January 14, 2019, the Company entered into an exclusivity agreement with a third -party to enter into a retail agreement (the "Retail Agreement") in exchange for 5,000,000 Inner Spirit common shares to the third-party at a price of $0.20 per share and a signing bonus. On February 6, 2019, the Retail Agreement was entered into whereby the Company will supply the use of Spirit Leaf's intellectual property and provide a sublease in exchange for a monthly fee based on a percentage of monthly gross sales.

iii) On March 5, 2019, the Company entered into a secured promissory note with a third-party for $1,500,000 that matures on July 5, 2019. The promissory note bears interest at a rate per annum of 12%, compounded daily and is payable on the maturity date of the note.