

**NORTHERN FINANCIAL CORPORATION**

**ANNUAL REPORT**

**MARCH 31, 2005**

**June 28, 2005**

## **To Our Shareholders**

### **Year in Review**

Northern Financial Corporation (“Northern” or the “Company”) and its wholly owned subsidiary, Northern Securities Inc. (“Northern Securities”), have made very good progress in our Capital Markets business as evidenced by the increase in our underwriting and advisory revenue. However, the Company will need to increase its commission revenue, which dropped about the same amount as the increase in underwriting and advisory revenue.

It is evident that the Company’s cost structure is too high; even by eliminating the provisions of \$548,000 taken by the Company, the loss for the year would only be reduced to \$2,628,000.

The results are unacceptable to management of the Company and will clearly be unacceptable to the Company’s shareholders. Management of the Company is committed to return more favourable results in fiscal 2006.

Our cost structure is too high and management will be taking steps to reduce our operating costs – this is a major priority. As a start on our cost reduction initiative, I will not be taking a salary in stock for fiscal 2006. On a positive note, the Company substantially increased the amount of cash and securities on its balance sheet in fiscal 2005. The Company made certain merchant banking investments that produced desired results.

Northern Securities participated in many financings in fiscal 2005. Among others, Northern Securities acted as sole underwriter on a \$6.5 million Forest Gate Resources Inc. private placement, as sole underwriter on a \$5.9 million Buffalo Oil Corporation private placement, sole underwriter on a \$2.65 million Expedition Energy Inc. private placement, sole underwriter on a \$2.1 million Marathon PGM Corporation initial public offering and sole underwriter on a \$2.0 million private placement for Marathon, lead underwriter on a \$5.5 million Absolute Software Corporation private placement, lead underwriter on a \$1.6 million Strategic Technologies Inc. private placement, co-underwriter on a \$143.8 million HudBay Minerals Inc. prospectus offering, co-underwriter on a \$15.0 million Systems Xcellence Inc. private placement, and co-underwriter on a \$25.0 million Constellation Copper Corporation private placement.

### **Organic Growth**

We continue to make great strides in attracting new people to Northern Securities. The key in the brokerage business is people. We try our very best to provide an excellent collegial, entrepreneurial environment at Northern Securities. This environment gives our people the ability to provide excellent service to our clients. Our clients are our business and our employees are expected to deliver outstanding service.

Northern has come through a series of acquisitions and while we will always look at opportunities as they become available, our main focus is organic growth. We want to attract the very best people. To do that, we need to strive for excellence in our dealings with our employees. This is the same excellence that we expect our employees to deliver to our clients.

### **Small Cap Niche Focused Securities Firm**

We search out unique, proprietary, distinctive, under-appreciated small cap companies. We become their champions. We trade their stock, we issue research reports and we raise capital and give advice. Small cap is our niche. Our mission is to provide small cap companies with the same high quality service enjoyed by large cap companies from their large cap focused investment banks.

We focus exclusively on small cap. This is Northern Securities' market niche – an enormous, under-serviced market niche in Canada.

On behalf of the Board of Directors, we thank our employees and shareholders for their continued support.

Vic Alboini  
Chairman and Chief Executive Officer

## MANAGEMENT'S DISCUSSION AND ANALYSIS

**June 28, 2005**

### Overview and Outlook

Subsequent to the March 31, 2005 year-end, Northern Financial Corporation (the "Company") commenced a number of undertakings to reduce certain brokerage expenses to better match revenue. The Company anticipates reducing the overall loss in fiscal 2006 as compared to fiscal 2005.

During fiscal 2005, Northern Securities Inc. ("Northern Securities") added people to its capital markets platform. This investment was key, as Northern Securities expands its presence in the small capitalization sector of the market. Northern Securities will continue to add selectively to its capital markets platform during fiscal 2006.

The Company balance sheet continues to be strong with \$15,190,476 in cash, deposits, securities and long-term investments at cost, as at March 31, 2005.

### Revenue

Total revenue for the year ended March 31, 2005 was \$15,037,055 compared with \$19,030,681 in the prior year; this represented a decrease of 21%. The decrease in revenue was a direct result of a reduced number of commission salespersons and proprietary traders employed in our Vancouver office.

Looking at specific revenues for the year ended March 31, 2005 compared to the prior year, commission revenue decreased by 36% to \$5,123,074 from \$7,986,101. Trading revenue decreased 82% to \$694,563 from \$3,892,539. Interest revenue increased 7% to \$1,616,433 from \$1,505,147.

Underwriting and advisory revenue increased 38% to \$7,486,029 from \$5,441,205 as a result of strong Mining and Oil and Gas sectors as well as a generally buoyant small capitalization sector where Northern Securities concentrates its business.

### Expenses

Total expenses for the year ended March 31, 2005, were \$18,213,789 compared with expenses of \$19,892,216 in the prior year. Brokerage operations costs decreased to \$15,486,357 from \$17,904,976. This decrease is attributable largely to the reduction in variable compensation paid by the Company.

Interest expense increased to \$1,089,367 from \$1,039,095, this represents a 5% increase which is attributable to a short-term loans payable incurred in the fourth quarter by the Company.

General and administrative increased to \$1,249,731 from \$510,975. This increase is attributable to an increase in share compensation provided by the Company. Depreciation and amortization expense is consistent with the prior year.

### Liquidity, Capital Resources and Cash Flows

The Company requires capital for operating and for regulatory purposes. Most of the assets reflected on the balance sheet are highly liquid. The Company's assets consist primarily of cash or assets that are readily convertible into cash. The value of securities that are held fluctuate with market values and may be affected by a variety of factors such as economic and market conditions.

The Company had cash, deposits, securities and long-term investments at cost of \$15,190,476 as at March 31, 2005 compared with \$6,570,626 as at March 31, 2004. The Company used \$2,091,664 of cash in its operations for the year ended March 31, 2005 compared to using \$1,435,372 last year.

Capital expenditures increased to \$6,231,089 for the year ended March 31, 2005 from \$205,347 for the year ended March 31, 2004. The increase is attributable to an increase in long-term investments of \$6,108,420, which was primarily the acquisition of shares of Proprietary Industries Inc.

The Company generated cash flow from financing activities in the amount of \$7,594,601 for the year ended March 31, 2005 compared to generating \$3,511,419 last year. The increase was primarily the result of the completion of certain private placements and the short-term loan payable incurred.

The Company in the past has always been able to generate sufficient amounts of cash and cash equivalents from the issuance of common shares, debentures or promissory notes. The Company has relied upon these methods to generate cash and cash equivalents to meet current working capital requirements.

A portion of the cash of the Company is maintained by Northern Securities. The Company must receive consent from Northern Securities' self-regulated organization prior to the repatriation of any cash.

The Company has never defaulted on any interest or dividend payments and currently has no amounts in arrears.

Outlined below are the contractual obligations including payments due for each of the next five years and thereafter:

#### Payments Due by Period

Contractual Obligations	Total	Less than 1 year	1 to 3 years	4 to 5 years	After 5 years
Long Term Debt	\$3,580,000	-	\$3,580,000	-	-
Operating Leases	\$2,487,000	\$1,220,000	\$1,242,000	\$25,000	-
Total Contractual Obligations	\$6,067,000	\$1,220,000	\$4,822,000	\$25,000	-

#### Annual Financial Information

	Year ended Mar. 31, 2005	Year ended Mar. 31, 2004	Year ended Mar. 31, 2003
Total revenues	\$15,037,055	\$19,030,681	\$6,536,428
Net loss from continuing operations	\$3,176,734	\$914,725	\$2,913,855
Net loss per share from continuing operations	\$0.00	\$0.00	\$0.01
Net loss	\$3,176,734	\$914,725	\$2,913,855
Net loss per share	\$0.00	\$0.00	\$0.01
Long term debt	\$3,451,000	\$893,000	\$784,600
Total assets	\$19,684,795	\$11,688,255	\$9,261,777

During fiscal 2003 Northern Securities acquired the securities business of Georgia Pacific Securities Corporation ("Georgia Pacific"), a securities dealer and also during fiscal 2003 the Company acquired the parent company of IPO Capital Corp. ("IPO Capital"), a securities dealer respectively.

These acquisitions significantly increase revenue and expenses of the Company.

#### Quarterly Financial Information

	Fiscal year ended March 31, 2005				Fiscal year ended March 31, 2004			
	\$							
	Fourth Quarter	Third Quarter	Second Quarter	First Quarter	Fourth Quarter	Third Quarter	Second Quarter	First Quarter
Total Revenues	5,989,669	4,463,719	2,184,769	2,398,898	6,258,226	5,273,847	3,981,448	3,517,160
Net Income (Loss)	366,439	(835,813)	(1,700,400)	(1,006,960)	(323,142)	301,662	(177,315)	(715,930)
Net Income (Loss) per share	0.00	(0.00)	(0.00)	(0.00)	(0.00)	0.00	(0.00)	(0.00)

During fiscal 2005, a larger portion of the Company's revenue was derived from underwriting and advisory revenue as compared with fiscal 2004. By nature, underwriting and advisory revenue is not readily predictable and is reported when transactions are complete. As this has led to large variations in total revenue reported by the Company. In addition, during fiscal 2005, the Company experienced a slow down in commission revenue, which led to the increase in quarterly losses as compared with fiscal 2004.

### **Change in Accounting Policy**

Effective April 1, 2004, the Company adopted the revisions to the CICA Handbook Section 3870, which require a fair value based method of accounting to be applied to all stock-based compensation arrangements. The fair value of each option is accounted for in operations, over the vesting period of the options, and the related credit is included in contributed surplus.

As a result of applying this change on a retroactive basis without restatement of comparative figures, a cumulative adjustment to the opening deficit balance of \$350,000 has been made. If the change had been made on a retroactive basis with restatement of comparative amounts, brokerage operating expenses, and deficit in the year ended March 31, 2004 would have increased by \$72,300. Contributed surplus at March 31, 2004 would have increased by \$350,000.

### **Financial Instruments**

The following is description and analysis of the risks associated with financial instruments that may affect the Company:

#### **Fair Value:**

Canadian generally accepted accounting principles require that the Company disclose information about the fair value of its financial assets and liabilities. Fair value estimates are made at the balance sheet date, based on relevant market information and information about the financial instrument. These estimates are subjective in nature and involve uncertainties in significant matters of judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect these estimates.

The carrying amounts for deposit with carrying broker, securities owned, accounts receivable, prepaid expenses and deposits, taxes recoverable, accounts payable and accrued liabilities and securities sold short on the balance sheet approximate fair value because of the limited term of these instruments.

#### **Risk Management:**

Risk management at the Company is an integrated process with independent oversight, which requires constant communication, judgment and knowledge of specialized products and markets. The Company's senior management takes an active role in the risk management process and has developed policies and procedures that require specific administration and business functions to assist in the identification, assessment and control of various risks.

#### **Market Risk:**

Market risk is the risk that a change in market prices, interest rate levels, indices, liquidity and other market factors will result in losses. The Company is exposed to market risk as a result of its principal trading in equity securities and fixed income securities. Securities held for trading are valued at market and as such, changes in market value affect earnings (losses) as they occur. The Company mitigates its market risk exposure through controls to limit concentration levels and capital usage within its inventory trading accounts.

#### **Credit Risk:**

The Company incurs credit risk when entering into, settling and financing various proprietary and client transactions. Credit risk arises from the potential that investees, clients or counterparties fail to satisfy their obligations. Credit risk is managed by dealing with counterparties the Company believes to be creditworthy and by actively monitoring credit exposure and the financial health of the counterparties.

#### **Interest Rate Risk:**

Interest rate risk arises from the possibility that changes in interest rates will affect the value of financial instruments. The Company does not hedge its exposure to interest rate risk as it is minimal.

**Foreign Exchange Risk:**

Foreign exchange risk is the risk that the market value of financial instruments and the associated revenues will fluctuate due to changes in exchange rates. The Company does not use derivatives to modify the foreign exchange risk.

**Share Capital Information**

Outlined below is selected current share capital information related to the Company:

<b>Description</b>	<b>Amount</b>
Common shares issued and outstanding	856,714,111
Common share purchase warrants issue and outstanding	24,947,720
Common share purchase options issue and outstanding	17,405,167
Unissued vested common shares pursuant to the Employee Equity Incentive Plan	3,200,000



McGovern, Hurley, Cunningham, LLP  
Chartered Accountants

**AUDITORS' REPORT**

To the Shareholders of  
**Northern Financial Corporation**

We have audited the consolidated balance sheets of Northern Financial Corporation as at March 31, 2005 and 2004 and the consolidated statements of operations and deficit and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at March 31, 2005 and 2004 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

**McGOVERN, HURLEY, CUNNINGHAM, LLP**

A handwritten signature in cursive script that reads "McGovern, Hurley, Cunningham, LLP".

**Chartered Accountants**

TORONTO, Canada  
June 21, 2005

NORTHERN FINANCIAL CORPORATION  
**CONSOLIDATED BALANCE SHEETS**  
AS AT MARCH 31

	2005 \$	2004 \$
<b>ASSETS</b>		
<b>CURRENT</b>		
Cash (Note 17)	3,440,518	4,168,670
Deposit with carrying broker (Note 5)	945,800	1,002,056
Securities owned, at market value (Note 6)	2,543,114	1,399,900
Accounts receivable	280,175	543,168
Prepaid expenses and deposits	127,845	193,547
Taxes recoverable	39,323	68,273
	<u>7,376,775</u>	<u>7,375,614</u>
<b>LONG-TERM INVESTMENTS</b> (Note 7)	8,261,044	-
<b>EQUIPMENT</b> (Note 8)	877,194	1,022,793
<b>GOODWILL</b> (Note 9(a))	3,024,468	3,024,468
<b>INTANGIBLE ASSETS</b> (Note 9(b))	145,314	265,380
	<u>19,684,795</u>	<u>11,688,255</u>
<b>LIABILITIES</b>		
<b>CURRENT</b>		
Accounts payable and accrued liabilities	2,629,796	2,025,872
Deferred revenue	50,000	-
Securities sold short, at market value (Note 6)	148,909	141,451
	<u>2,828,705</u>	<u>2,167,323</u>
<b>DEBENTURES PAYABLE</b> (Note 11)	951,000	893,000
<b>PROMISSORY NOTE PAYABLE</b> (Note 10)	2,500,000	-
<b>TOTAL LIABILITIES</b>	<u>6,279,705</u>	<u>3,060,323</u>
<b>CONTINGENCIES</b> (Note 14)		
<b>SHAREHOLDERS' EQUITY</b>		
<b>CAPITAL STOCK</b> (Note 12(a))	41,617,237	79,446,620
<b>WARRANTS</b> (Note 12(e))	453,144	761,369
<b>CONTRIBUTED SURPLUS</b> (Note 12(f))	1,033,175	554,950
<b>DEFICIT</b>	<u>(29,698,466)</u>	<u>(72,135,007)</u>
	<u>13,405,090</u>	<u>8,627,932</u>
	<u>19,684,795</u>	<u>11,688,255</u>

APPROVED ON BEHALF OF THE BOARD:

Signed "VIC ALBOINI" \_\_\_\_\_, Director

Signed "IAN BRADLEY" \_\_\_\_\_, Director

NORTHERN FINANCIAL CORPORATION  
**CONSOLIDATED STATEMENTS OF OPERATIONS AND DEFICIT**  
FOR THE YEARS ENDED MARCH 31

	2005 \$	2004 \$
<b>REVENUES</b>		
Commissions	5,123,074	7,986,101
Underwriting and advisory	7,486,029	5,441,205
Trading – net	694,563	3,892,539
Interest	1,616,433	1,505,147
Other	116,956	205,689
Total revenues	<u>15,037,055</u>	<u>19,030,681</u>
<b>OPERATING EXPENSES</b>		
Brokerage operations	15,486,357	17,904,976
General and administrative	1,249,731	510,975
Long-term debt interest expense	182,954	144,215
Other interest expense	906,413	894,880
Depreciation and amortization	388,334	437,170
Total operating expenses	<u>18,213,789</u>	<u>19,892,216</u>
Loss before income taxes	(3,176,734)	(861,535)
Income taxes (Note 13(a))	-	53,190
<b>NET LOSS FOR THE YEAR</b>	<u>(3,176,734)</u>	<u>(914,725)</u>
<b>REDUCTION OF STATED CAPITAL</b> (Note 12(a)(ii))	45,963,275	-
<b>CHANGE IN ACCOUNTING POLICY</b> (Note 2)	(350,000)	-
<b>DEFICIT</b> , beginning of year	<u>(72,135,007)</u>	<u>(71,220,282)</u>
<b>DEFICIT</b> , end of year	<u>(29,698,466)</u>	<u>(72,135,007)</u>
<b>LOSS PER SHARE</b> – Basic and diluted	(0.00)	(0.00)
<b>WEIGHTED AVERAGE COMMON SHARES OUTSTANDING</b>	709,479,050	489,239,484

See accompanying notes to the consolidated financial statements.

NORTHERN FINANCIAL CORPORATION  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
 FOR THE YEARS ENDED MARCH 31

	2005 \$	2004 \$
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net loss for the year	(3,176,734)	(914,725)
Items not involving cash:		
Depreciation and amortization	388,334	437,170
Shares issued for services	706,667	-
Accretion of debentures	58,000	18,400
	<u>(2,023,733)</u>	<u>(459,155)</u>
Changes in non-cash working capital balances:		
Deposit with carrying broker	56,256	350,543
Securities owned	(1,143,214)	(1,295,696)
Accounts receivable	262,993	(30,567)
Prepaid expenses and deposits	65,702	208,139
Income taxes	28,950	(20,020)
Accounts payable and accrued liabilities	603,924	(322,250)
Securities sold short	7,458	133,634
Deferred revenue	50,000	-
	<u>(67,931)</u>	<u>(976,217)</u>
Cash flows from operating activities	<u>(2,091,664)</u>	<u>(1,435,372)</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Acquisition of equipment (net)	(122,669)	(194,470)
Acquisition of long-term investments	(6,108,420)	-
Acquisition of intangible assets	-	(10,877)
Cash flows from investing activities	<u>(6,231,089)</u>	<u>(205,347)</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Debentures payable issued	-	1,080,000
Repayment of debentures	-	(140,000)
Promissory note issued	2,500,000	-
Proceeds from exercising stock options	26,217	49,990
Proceeds from issuance of common stock pursuant to acquisition (Note 12(a)(v))	1,027,384	-
Principal repayments on long-term debt	-	(50,848)
Proceeds from private placements, net of issue costs	3,750,000	2,001,423
Costs of issue of non-cash share issuances	-	(34,379)
Proceeds from exercising warrants	291,000	605,233
Cash flows from financing activities	<u>7,594,601</u>	<u>3,511,419</u>
(Decrease) increase in cash	(728,152)	1,870,700
Cash, beginning of year	<u>4,168,670</u>	<u>2,297,970</u>
Cash, end of year	<u>3,440,518</u>	<u>4,168,670</u>

**SUPPLEMENTAL INFORMATION** (Note 17)

See accompanying notes to the consolidated financial statements.

NORTHERN FINANCIAL CORPORATION  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**  
FOR THE YEARS ENDED MARCH 31, 2005 AND 2004

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**1. NATURE OF OPERATIONS**

In 1999, Northern Financial Corporation (the "Company") acquired Northern Securities Inc. ("NSI"), a member firm of the Investment Dealers Association ("IDA"). The Company carries on a traditional brokerage business as well as an online brokerage business.

**2. CHANGE IN ACCOUNTING POLICY**

Effective April 1, 2004, the Company adopted the revisions to the CICA Handbook Section 3870, which require a fair value based method of accounting to be applied to all stock-based compensation arrangements. The fair value of each option is accounted for in operations, over the vesting period of the options, and the related credit is included in contributed surplus.

As a result of applying this change on a retroactive basis without restatement of comparative figures, a cumulative adjustment to the opening deficit balance of \$350,000 has been made. If the change had been made on a retroactive basis with restatement of comparative amounts, brokerage operating expenses, and deficit in the year ended March 31, 2004 would have increased by \$72,300. Contributed surplus at March 31, 2004 would have increased by \$350,000.

**3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

The accounting policies of the Company are in accordance with generally accepted accounting principles in Canada and are consistent with that of the previous year. Outlined below are those policies considered particularly significant:

**Principles of consolidation:**

These consolidated financial statements include the accounts of the Company and all its subsidiaries. All significant intercompany accounts and balances have been eliminated upon consolidation.

**Foreign currency translation:**

Monetary assets and liabilities are translated at the rate of exchange prevailing at the year end; equipment and intangible assets are translated at the rates prevailing at the acquisition dates; and revenue and expenses are translated at average rates of exchange during the year, with the exception of amortization which is translated at historical exchange rates. Exchange gains and losses are included in the consolidated statement of operations and deficit.

**Securities owned and securities sold short:**

Securities owned and securities sold short are stated at market values at the balance sheet date. Realized and unrealized changes in fair value are recognized in income from principal transactions in the period in which the changes occur.

**Equipment:**

Equipment is recorded at cost less accumulated depreciation. Depreciation is provided on a declining-balance basis at the following annual rates:

Office equipment	20%
Leasehold improvements	20%
Computer hardware	30%

Art is not depreciated.

**Goodwill and intangible assets:**

The Company has unamortized goodwill, which arose from previous acquisitions, of \$3,024,468 which is no longer being amortized. Goodwill is tested for impairment annually or more frequently if events or changes in circumstances indicate the asset may be impaired.

Computer software is amortized 50% in the year of acquisition and 50% in the year thereafter.

Client agreements and relationships are amortized on a straight-line basis over their estimated useful lives of three years and are tested annually for impairment.

Patents and trademarks are amortized on a straight line basis over their estimated useful lives of ten years and are tested annually for impairment.

**Long-term investments:**

Long-term investments are carried at cost. If it is determined that an investment has suffered a decline in value that is other than temporary, it is written down to its net realizable value.

**Revenue recognition:**

Securities transactions and related revenues are recorded on a trade-date basis. Commission expenses related to transactions executed but not settled have been included in the accounts. Underwriting and advisory revenues are recorded at the time the transaction or service is completed and the related income is reasonably determinable. Principal trading relates to net gains through proprietary trading of securities. Securities owned and securities sold short are stated at market value at the balance sheet date resulting in unrealized gains and losses being reflected in income.

NORTHERN FINANCIAL CORPORATION  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**  
 FOR THE YEARS ENDED MARCH 31, 2005 AND 2004

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**Use of estimates:**

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**Leases:**

Leases have been classified as either capital or operating. A lease which transfers substantially all of the benefits and risks incidental to the ownership of property is accounted for as if it were an acquisition of an asset and the incurrence of an obligation at the inception of the lease. All other leases are accounted for as operating leases wherein rental payments are charged to operations as incurred. Assets recorded under the capital leases are amortized on a declining balance basis over their estimated useful lives.

**Stock-based compensation plan:**

The Company records as compensation all stock-based awards made to non-employees and employees at fair value. Any consideration paid exercise of stock options is credited to capital stock. The Company's stock-based compensation plans are described further in Notes 12(c) and (d).

**Income taxes:**

The Company accounts for and measures future tax assets and liabilities in accordance with the liability method. Under this method, future tax assets and liabilities are recognized for future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Future tax assets and liabilities are measured using enacted or substantively enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on future tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the date of enactment or substantive enactment of the change. When the future realization of income tax assets does not meet the test of being more likely than not to occur, a valuation allowance in the amount of the potential future benefit is taken and no net asset is recognized.

**Loss per share:**

Basic loss per share is calculated using the weighted average number of shares outstanding. Diluted loss per share is calculated using the treasury stock method. In order to determine diluted loss per share, the treasury stock method assumes that any proceeds from the exercise of dilutive stock options and warrants would be used to repurchase common shares at the average market price during the period, with the incremental number of shares being included in the denominator of the diluted loss per share calculation. The diluted loss per share calculation excludes any potential conversion of options and warrants that would increase earnings per share or decrease loss per share.

**4. ACQUISITION**

On March 31, 2003 and during April 2003, the Company acquired 100% of the outstanding shares of 1279514 Ontario Inc., which owns 100% of IPO Capital Corp (collectively "IPO"), a brokerage firm with offices in Toronto and Vancouver, for cash consideration of \$343,157 and the issuance of 26,253,388 common shares of the Company with a fair value of \$840,109. The Company also incurred acquisition costs totaling \$168,200. The acquisition was accounted for by the purchase method of accounting.

The purchase price was allocated as follows:

Cash and cash equivalents	\$1,588,480
Other current assets	150,520
Equipment	112,000
Current liabilities	<u>(169,000)</u>
Fair value acquired	1,682,000
Purchase price	<u>1,351,466</u>
	330,534
Allocation of negative goodwill to equipment and restructuring costs	<u>(330,534)</u>
	<u>\$ -</u>

The purchase price allocation determined that there was fair value greater than the purchase price. This negative goodwill was allocated as a pro-rata reduction of assets except for financial assets, assets to be disposed of by sale, future income tax assets and prepaid assets.

**5. SERVICE AGREEMENT**

The Company has contracted Penson Financial Services ("Penson") to perform certain trading and clearing activities for clients of the Company, according to the Introducing Broker Agreement (the "Agreement") between Penson and the Company. As a Type 2 Introducing Broker, the Company does not carry client accounts, nor receive, deliver or hold cash and securities in connection with such clients. At March 31, 2005, the Company maintained a deposit with Penson of \$945,800 (2004 - \$925,689), which cannot be used in the normal course of operations. Deposits with carrying broker at March 31, 2004 included deposits of \$97,104 held with another carrying broker. As at March 31, 2005, Penson had offset \$646,000 (2004 - \$Nil) against

NORTHERN FINANCIAL CORPORATION  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**  
 FOR THE YEARS ENDED MARCH 31, 2005 AND 2004

this deposit for under margined and delinquent accounts of clients of the Company. Penson performs its services for a flat fee per trade, subject to certain additional charges. Interest related to client accounts is also split according to the Agreement.

**6. SECURITIES OWNED AND SECURITIES SOLD SHORT**

Securities owned consist of the following:

	2005 \$	2004 \$
Publicly traded equities	1,593,114	1,032,900
Broker warrants	950,000	367,000
	<u>2,543,114</u>	<u>1,399,900</u>

Securities sold short consist of the following:

	2005 \$	2004 \$
Publicly traded equities	<u>148,909</u>	<u>141,451</u>

**7. LONG-TERM INVESTMENTS**

Long-term investments consist of the following:

	2005 \$
Proprietary Industries Inc. ("PPI")	6,804,390
Other marketable securities	1,456,909
	<u>8,261,044</u>

The Company's investment in PPI represents 14.8% of the outstanding common shares of PPI and includes the cost of shares paid for in cash by the Company of \$3,675,592, 86,104,920 shares of the Company exchanged for shares of PPI valued at \$2,152,624 and transaction costs of \$976,174. The market value of the Company's investment in PPI at March 31, 2005 was approximately \$6,100,000. See Note 14(d).

The Company holds other long-term investments with a market value of approximately \$1,100,000 as at March 31, 2005.

Management believes that the decline in market value of these long-term investments is temporary in nature and that the market is currently undervaluing certain of its long-term investments. As a result, no impairment has been recognized on long-term investments. If it is subsequently determined that there has been other than a temporary decline in the market value of these investments below the carrying value the Company may recognize an impairment charge on the carrying value of its investments which could be material.

**8. EQUIPMENT**

	2005		
	Cost \$	Accumulated Amortization \$	Net \$
Office equipment	683,262	393,213	290,049
Leasehold improvements	393,381	201,325	192,056
Computer hardware	1,464,750	1,082,575	382,175
Art	12,914	-	12,914
	<u>2,554,307</u>	<u>1,677,113</u>	<u>877,194</u>
	2004		
	Cost \$	Accumulated Amortization \$	Net \$
Office equipment	670,833	322,254	348,579
Leasehold improvements	368,437	156,429	212,008
Computer hardware	1,395,501	944,374	451,127
Art	11,079	-	11,079
	<u>2,445,850</u>	<u>1,423,057</u>	<u>1,022,793</u>

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**9. GOODWILL AND INTANGIBLE ASSETS**

**a) Goodwill:**

	2005 \$	2004 \$
Balance	3,024,468	3,024,468

Management has calculated the fair market value of the publicly traded stock of the Company and compared it to the book value of the stock and concluded that there was no impairment of goodwill.

**b) Intangible Assets:**

	2005		
	Cost \$	Accumulated Amortization \$	Net \$
Client agreements and relationships	377,000	252,181	124,819
Computer software	519,308	503,772	15,536
Patents and trademarks	8,624	3,665	4,959
	<u>904,932</u>	<u>759,618</u>	<u>145,314</u>

  

	2004		
	Cost \$	Accumulated Amortization \$	Net \$
Client agreements and relationships	377,000	125,960	251,040
Computer software	507,720	499,202	8,518
Patents and trademarks	8,624	2,802	5,822
	<u>893,344</u>	<u>627,964</u>	<u>265,380</u>

**10. PROMISSORY NOTE PAYABLE**

As at March 31, 2005, the Company had a promissory note payable outstanding in the amount of \$2,500,000. The promissory note payable matures on May 17, 2006, bears interest at 13% and is secured by certain long-term investments of the Company with a carrying amount of approximately \$7,900,000 and a market value of approximately \$6,900,000, a general security agreement, covering all property of the Company, and a personal guarantee by the President of the Company. A director of the Company is also a director and officer of the trustee of the promissory note payable.

**11. DEBENTURES PAYABLE**

As at March 31, 2005, the Company had issued debentures with a principal face value of \$1,080,000. The debentures are unsecured, mature on December 31, 2006, carry a 9% interest rate and have ten share purchase warrants for each dollar of principal amount issued. The share purchase warrants have an exercise price of \$0.03 up to December 31, 2005 and an exercise price of \$0.05 up to December 31, 2006.

The warrants were valued at \$200,000 using the Black-Scholes pricing model with the following assumptions: Expected dividend yield of 0%, expected volatility of 100%, risk free interest rate of 3%, and an expected life of three years.

**12. CAPITAL STOCK**

**a) Share Capital:**

Authorized:

Unlimited number of common shares  
 2,000,000 voting, convertible, redeemable preference shares

Issued and outstanding:

856,714,111 common shares

\$41,617,237

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Share capital activity for the years ended March 31, 2005 and 2004 is summarized as follows:

	Shares #	Amount \$
Balance March 31, 2003	397,879,389	75,160,082
Common shares released from escrow	6,000,775	202,351
Settlement of subordinated loan (vi)	20,000,000	264,334
Services and debt settlements	38,053,085	772,669
Private placement	31,129,230	1,679,521
Conversion of debentures payable (vii)	43,333,333	615,621
Exercise of stock options issued	1,333,416	49,990
Exercise of warrants issued	21,624,444	702,052
Balance outstanding, March 31, 2004	559,353,672	79,446,620
Private placements (i)	135,151,514	3,750,000
Reduction of stated capital (ii)	-	(45,963,275)
Exercise of stock options issued	676,666	26,217
Exercise of warrants	9,700,000	471,000
Shares issued as management compensation (iii)	14,704,729	571,667
Settlement of credit facility commitment obligation (iv)	3,375,000	135,000
Shares issued to acquire Sylre (v)	47,647,609	1,027,384
Shares issued to acquire investment in PPI (Note 7)	86,104,920	2,152,624
Balance outstanding, March 31, 2005	856,714,111	41,617,237

- (i) During 2005, the Company raised gross proceeds of \$3,750,000 upon the completion of private placements for the issuance of 135,151,514 common shares of the Company as follows: 53,333,333 common shares at \$0.01875 per share, 33,333,333 common shares at \$0.0225 per share, and 48,484,848 common shares at \$0.04125 per share. A total of 55,098,321 shares for gross proceeds of \$1,287,909 were subscribed for by the President of the Company, a family member of the President of the Company, and a corporation controlled by the President of the Company. An additional 4,144,528 common shares for gross proceeds of \$140,127 were subscribed for by a director of the Company.
- (ii) The Company eliminated the accumulated deficit relating to its previous mining operations by reducing share capital as ratified by shareholders at the September 30, 2004 annual and special meeting of shareholders.
- (iii) Certain employees receive a portion of their compensation in common shares of the Company. During 2005, 14,704,729 common shares were granted to employees in settlement of compensation amounts.
- (iv) The Company issued 3,375,000 common shares to settle amounts due of \$135,000 in connection with a credit facility arrangement.
- (v) The Company acquired 100% of the outstanding common shares of Sylre Ltd. ("Sylre"). Sylre had no operations at the time of acquisition and the acquisition has therefore been recorded as a financing transaction. The Company issued 47,647,609 common shares and acquired cash totaling \$1,027,384 net of transaction costs of \$525,661 and cash paid for Sylre shares. Subsequent to the year-end, the Company disposed of its controlling interest in Sylre.
- (vi) During 2004, a subordinated loan of \$300,000 was converted into 20,000,000 common shares of the Company valued at \$264,334 after issue costs.
- (vii) During 2004, \$650,000 of debentures were converted into 43,333,333 common shares of the Company valued at \$615,621 after issue costs.
- (viii) Shares issue costs during 2004 totaled \$172,716.

**b) Capital Requirements:**

The Company's investment dealer subsidiary, NSI, is subject to rules of the IDA which require NSI to maintain a certain level of regulatory capital. This capital was provided by the Company and is eliminated upon consolidation as a loan between the parent and subsidiary.

As at March 31, 2005 the capital of NSI exceeded the requirements of the IDA.

**c) Stock Options:**

Effective August 28, 2003 the Company discontinued the stock option plan (the "Plan"), whereby no further options will be granted pursuant to the Plan and all options outstanding will remain in effect until either exercised or cancelled.

As at March 31, 2005, there were 17,405,167 common share purchase options outstanding, expiring at various dates to January 21, 2013. The options have an exercise price equal to the Company's market closing share price on the day prior to the date of grant and vest over the first twenty-four or thirty months, in equal monthly installments, beginning in the month of grant, and are exercisable over ten years.

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Stock option activity for the years ended March 31, 2004 and 2005 is summarized as follows:

	Stock Options #	Weighted Average Exercise Price \$
Balance March 31, 2003	33,186,940	0.19
Granted	650,000	0.03
Cancelled	(6,341,940)	0.10
Expired	(6,283,500)	0.55
Exercised	(1,333,416)	0.12
Balance March 31, 2004	<u>19,878,084</u>	0.14
Cancelled	(1,796,250)	0.11
Exercised	(676,667)	0.04
Balance March 31, 2005	<u><u>17,405,167</u></u>	0.14

The following is a summary of common share purchase options outstanding as at March 31, 2005:

Range of Exercise Prices \$	Stock Options #	Average Remaining Life (Years)	Weighted Average Price \$
0.035-0.10	14,063,667	4.2	0.06
0.30-0.70	<u>3,341,500</u>	3.9	0.48
	<u><u>17,405,167</u></u>	4.1	0.14

**d) Employee Equity Incentive Plan:**

On September 30, 2004, the shareholders of the Company approved the establishment of an equity incentive plan whereby up to 6% of the outstanding common shares of the Company may be issued annually to certain new or existing employees of the Company as a means of attracting and retaining exceptional employees.

During the year ended March 31, 2005, the following transactions pursuant to the equity incentive plan took place:

- 12,500,000 shares were granted, vesting in equal installments on June 1, 2005, 2006 and 2007. 3,500,000 of these grants were cancelled prior to vesting requirements being met;
- 600,000 shares were granted vesting in equal installments on June 15, 2005 and 2006; and
- \$100,000 of shares were granted vesting on each of August 2, 2005, 2006 and 2007.

As at March 31, 2005, the granted shares had not been issued as the plan is subject to regulatory approval. Included in accounts payable and accrued liabilities is approximately \$170,000 related to these shares.

**e) Warrants:**

As at March 31, 2005, there were 24,947,720 common share purchase warrants issued and outstanding, expiring at various dates to December 31, 2006.

Common share purchase warrant activity for the years ended March 31, 2004 and 2005 is summarized as follows:

	Warrants #	Weighted Average Exercise Price \$
Balance, March 31, 2003	49,566,276	0.05
Granted	23,469,387	0.07
Exercised	(21,624,443)	0.03
Expired	(8,819,500)	0.07
Balance, March 31, 2004	<u>42,591,720</u>	0.07
Exercised	(9,700,000)	0.03
Expired	(7,944,000)	0.10
Balance, March 31, 2005	<u><u>24,947,720</u></u>	0.07

The fair value of the warrants granted during 2004 at the date of grant was estimated using the Black-Scholes option pricing model based on the following assumptions: risk-free interest rate of 3%; expected life of three years; dividend rate of 0%; and volatility of 100%.

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The following is a summary of common share purchase warrants outstanding as at March 31, 2005:

Date of Grant	Date of Expiry	Warrants #	Exercise Price \$
August 15, 2001	August 15, 2006	10,500,000	0.05
September 16, 2001	September 16, 2006	66,666	0.05
November 18, 2001	November 18, 2006	791,667	0.04
April 30, 2003	April 30, 2005	77,580	0.03
December 19, 2003	December 31, 2006	400,000	0.03
January 26, 2004	January 26, 2007	700,000	0.03
February 20, 2004	February 20, 2006	9,839,807	0.10
February 25, 2004	February 25, 2006	<u>2,572,000</u>	0.10
		<u>24,947,720</u>	

**f) Contributed surplus:**

Contributed surplus activity for the years ended March 31, 2005 and 2004 is summarized as follows:

	\$
Balance, March 31, 2003	469,933
Expired warrants	<u>85,017</u>
Balance, March 31, 2004	554,950
Change in accounting policy (Note 2)	350,000
Expired warrants	<u>128,225</u>
	<u>1,033,175</u>

**13. INCOME TAXES**

**a) Provision for Income Taxes**

Major items causing the Company's income tax rate to differ from the Canadian combined federal and provincial statutory rate of approximately 36% (2004 - 37%) approximated the following:

	2005 \$	2004 \$
Loss before taxes	<u>(3,176,734)</u>	<u>(861,535)</u>
Expected income tax (benefit) based on statutory rate	(1,147,000)	(319,000)
Increase (decrease) resulting from:		
Finance costs	(155,000)	(148,000)
Amortization	<u>140,000</u>	<u>384,000</u>
	(1,162,000)	(83,000)
Current year valuation allowance	<u>1,162,000</u>	<u>136,190</u>
Income Tax Expense	<u>-</u>	<u>53,190</u>

**b) Future Tax Balances**

The tax effects of temporary differences that give rise to future income tax assets in Canada approximate the following:

	2005 \$	2004 \$
Future tax assets		
Non-capital losses carried forward	9,097,000	8,512,000
Share issue costs	170,000	437,000
Equipment and intangible assets	1,693,000	842,000
Resource deductions	<u>1,529,000</u>	<u>1,566,000</u>
	12,489,000	11,357,000
Valuation allowance	<u>(12,489,000)</u>	<u>(11,357,000)</u>
Total	<u>-</u>	<u>-</u>

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The Company has loss carry forwards in Canada of approximately \$25,184,000, which under certain circumstances may be utilized to offset future taxable income. These losses expire as follows:

2006	\$ 1,694,000
2007	6,281,000
2008	7,888,000
2009	1,740,000
2010	3,252,000
2011	1,112,000
2015	<u>3,217,000</u>
Total	<u>\$25,184,000</u>

**14. COMMITMENTS AND CONTINGENCIES**

- a) The Company has indemnified Penson for all obligations to pay for securities purchased and to deliver securities sold by clients. In the event of default by any of its clients on payments due or delivery of securities to Penson, the Company has agreed to pay Penson an amount up to its "excess risk adjusted capital". As at March 31, 2005, the amount of the Company's excess risk adjusted capital was \$1,306,000 (2004 - \$1,772,000).
- b) The Company is party to legal proceedings in the ordinary course of its operations. Management does not expect the outcome of any of these proceedings to have a materially adverse effect on the results of the Company's financial position or operations.
- IPO has been named in an action brought by two investors in the aggregate amount of approximately US\$100,000 and CDN\$75,000. In the opinion of management, IPO has good defences to these actions, however it is premature to make an estimate of the potential outcome or financial impact of this action.
  - Two former employees are seeking a breach of contract judgement in the amount of \$231,460. The Company believes the action is wholly without merit and has made a counterclaim.
  - A client of IPO has commenced a class action proceeding against the Company claiming damages. It is premature to evaluate the Company's exposure related to this claim.

Litigation is subject to many uncertainties and the outcome of individual matters is not predictable. It is possible that the final resolution of these matters may require the Company to make expenditures over an extended period of time and in a range of amounts that cannot be reasonably estimated and may differ significantly from any amounts recorded in these consolidated financial statements.

- c) The future minimum annual payments for each fiscal year on equipment and office premises under existing operating leases approximate the following:

2006	1,220,000
2007	767,000
2008	440,000
2009	35,000
2010	<u>25,000</u>
Total	<u>2,487,000</u>

The Company has included its share of estimated operating costs and realty taxes with respect to the leased premises.

- c) Under the terms of the asset purchase agreement with Georgia Pacific Securities Corporation ("GP") dated December 20, 2002, the Company is contingently liable to pay 50% of the profits resulting from the GP operations for the next three years to a maximum of approximately \$2,500,000. For the years ended March 31, 2005 and 2004, there were no profits from the GP operations and therefore no amount payable pursuant to the agreement.
- d) The Company is required to share certain gains on disposal, if any, of its investment in PPI. See Note 7.
- e) The Company has available a credit facility in the amount of \$250,000 at prime plus 1%, secured by a general security agreement covering all assets of the Company and certain guarantees provided personally by the President of the Company and a corporation controlled by the President of the Company. As at March 31, 2005, no amounts were owing under the credit facility.

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## 15. FINANCIAL INSTRUMENTS

### Fair Value:

Canadian generally accepted accounting principles require that the Company disclose information about the fair value of its financial assets and liabilities. Fair value estimates are made at the balance sheet date, based on relevant market information and information about the financial instrument. These estimates are subjective in nature and involve uncertainties in significant matters of judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect these estimates.

The carrying amounts for deposit with carrying broker, securities owned, accounts receivable, prepaid expenses and deposits, taxes recoverable, accounts payable and accrued liabilities, and securities sold short on the balance sheet approximate fair value because of the limited term of these instruments.

### Risk Management:

Risk management at the Company is an integrated process with independent oversight, which requires constant communication, judgment and knowledge of specialized products and markets. The Company's senior management takes an active role in the risk management process and has developed policies and procedures that require specific administration and business functions to assist in the identification, assessment and control of various risks.

### Market Risk:

Market risk is the risk that a change in market prices, interest rate levels, indices, liquidity and other market factors will result in losses. The Company is exposed to market risk as a result of its principal trading in equity securities and fixed income securities. Securities held for trading are valued at market and as such, changes in market value affect earnings (losses) as they occur. The Company mitigates its market risk exposure through controls to limit concentration levels and capital usage within its inventory trading accounts.

### Credit Risk:

The Company incurs credit risk when entering into, settling and financing various proprietary and client transactions. Credit risk arises from the potential that investees, clients or counterparties fail to satisfy their obligations. Credit risk is managed by dealing with counterparties the Company believes to be creditworthy and by actively monitoring credit exposure and the financial health of the counterparties.

### Interest Rate Risk:

Interest rate risk arises from the possibility that changes in interest rates will affect the value of financial instruments. The Company does not hedge its exposure to interest rate risk as it is minimal.

### Foreign Exchange Risk:

Foreign exchange risk is the risk that the market value of financial instruments and the associated revenues will fluctuate due to changes in exchange rates. The Company does not use derivatives to modify the foreign exchange risk.

## 16. RELATED PARTY TRANSACTIONS

The Company had the following transactions, excluding compensation, with the President of the Company and a corporation controlled by the President of the Company:

	2005	2004
	\$	\$
Expenses paid or accrued during the year ended March 31:		
Interest expense	-	4,654
Transactions involving shares and warrants during the year ended March 31, 2004 were as follows:	Shares	Amount
Settlement of interest with shares	#	\$
	153,166	4,654

All of the above transactions are in the normal course of operations and are recorded at the exchange amounts, being the amounts established and agreed to by the related parties.

See Notes 10 and 12(a)(i).

NORTHERN FINANCIAL CORPORATION  
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**17. SUPPLEMENTAL INFORMATION – STATEMENT OF CASH FLOWS**

	2005	2004
	\$	\$
Interest paid	1,089,367	279,757
Debt and services settled by the issuance of shares	-	773,769
Debentures settled by the issuance of shares	-	650,000
Settlement of subordinated loan by the issuance of shares	-	300,000
Shares issued to acquire PPI (Note 7)	2,152,624	-
<b>Cash consists of the following:</b>		
Cash	1,158,563	1,248,749
Due from carrying broker	2,281,955	2,919,921
	<u>3,440,518</u>	<u>4,168,670</u>

**18. COMPARATIVE FIGURES**

Certain comparative figures have been restated to conform with the current year's presentation.

**19. SUBSEQUENT EVENTS**

Subsequent to the year-end, as part of certain merchant banking initiatives of the Company, certain guarantees were made against potential losses. The maximum guaranteed under these arrangements to June 21, 2005 was approximately \$836,000. As at June 21, 2005, there was no liability under these guarantees.

See Note 12(a)(v).

## **CORPORATE INFORMATION**

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### **BOARD OF DIRECTORS**

Vic Alboini, *Chairman*  
Ian Bradley  
*Chief Financial Officer*  
*PBB Global Logistics*  
Wesley Roitman  
*Partner*  
*Romspen Investment Corporation*

### **SHARE INFORMATION**

Listed on the Toronto Stock Exchange under the trading symbol **NFC**

### **TRANSFER AGENT**

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