

Holloway Lodging Real Estate Investment Trust

Consolidated Financial Statements
December 31, 2010 and 2009

March 8, 2011

Management's Responsibility for Financial Reporting

The accompanying consolidated financial statements of **Holloway Lodging Real Estate Investment Trust** (the "REIT") have been prepared by the REIT's management. The financial statements have been prepared in accordance with Canadian generally accepted accounting principles and contain estimates based on management's judgment. Internal control systems are maintained by management to provide reasonable assurances that assets are safeguarded and financial information is reliable.

The Board of Trustees of the REIT is responsible for ensuring that management fulfils its responsibilities for financial reporting and is ultimately responsible for reviewing and approving the consolidated financial statements and the accompanying management discussion and analysis. The Board of Trustees carries out this responsibility principally through its Audit Committee.

The Audit Committee is appointed by the Board of Trustees and all of its members are independent. It meets with the REIT's management and auditors and reviews internal control and financial reporting matters to ensure that management is properly discharging its responsibilities before submitting the consolidated financial statements to the Board of Trustees for approval.

(signed) "*W. Glenn Squires*"
Chief Executive Officer

(signed) "*Tracy C. Sherren*"
Chief Financial Officer

March 8, 2011

Independent Auditor's Report

**To the Trustees of
Holloway Lodging Real Estate Investment Trust**

PricewaterhouseCoopers LLP
Chartered Accountants
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We have audited the accompanying consolidated financial statements of consolidated **Holloway Lodging Real Estate Investment Trust** which comprise the balance sheet as at December 31, 2010 and the statements of operations and comprehensive loss, unitholders' equity and cash flow for the year then ended, and the related notes including a summary of significant accounting policies.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with Canadian generally accepted accounting principles, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

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

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

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

Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of **Holloway Lodging Real Estate Investment Trust** as at December 31, 2010 and its financial performance and its cash flows for the year then ended in accordance with Canadian generally accepted accounting principles.

(signed) "*PricewaterhouseCoopers LLP*"

Chartered Accountants

Holloway Lodging Real Estate Investment Trust

Consolidated Balance Sheet

As at December 31, 2010 and 2009

(in thousands of dollars)

	2010 \$	2009 \$
Assets		
Current assets		
Cash and cash equivalents (note 14)	830	3,756
Capital reserve	921	912
Restricted cash	551	560
Accounts receivable	2,962	2,438
Inventories	261	280
Prepaid expenses and deposits	2,608	4,479
Assets of discontinued operations	—	717
	<hr/>	<hr/>
	8,133	13,142
Capital reserve – restricted	5,440	4,691
Loans receivable from related parties (note 3)	6,398	6,509
Investments in hotel properties (note 5)	1,217	1,961
Property and equipment (note 6)	313,374	326,465
Other assets (note 7)	718	877
Future income taxes (note 21)	7,082	4,566
	<hr/>	<hr/>
	342,362	358,211
Liabilities		
Current liabilities		
Line of credit (note 8)	2,519	—
Accounts payable and accrued liabilities	8,595	7,856
Accrued interest on convertible debentures	675	675
Current portion of obligations under capital leases (note 9)	132	285
Current portion of mortgages and loans payable (note 10)	41,034	4,953
Current portion of convertible debentures (note 12)	19,138	—
Liabilities of discontinued operations	—	638
	<hr/>	<hr/>
	72,093	14,407
Obligations under capital leases (note 9)	90	222
Mortgages and loans payable (note 10)	111,559	148,530
Promissory notes payable (note 11)	3,203	3,405
Convertible debentures (note 12)	49,597	65,935
	<hr/>	<hr/>
	236,542	232,499
Unitholders' Equity	<hr/>	<hr/>
	105,820	125,712
	<hr/>	<hr/>
	342,362	358,211
Commitments and contingencies (note 17)		

Approved by the Trustees

(signed) _____

(signed) _____

Holloway Lodging Real Estate Investment Trust

Consolidated Statement of Unitholders' Equity

As at December 31, 2010 and 2009

(in thousands of dollars)

	Units \$ (note 13)	Class B LP units \$ (note 13)	Contributed surplus \$	Equity component of convertible debentures \$	Accumulated income (losses) \$	Accumulated distributions \$	Total \$
Balance, December 31, 2008	180,088	667	1,295	9,596	(4,768)	(36,784)	150,094
Unit-based compensation related to options	—	—	64	—	—	—	64
Net loss	—	—	—	—	(20,337)	—	(20,337)
Distributions	—	—	—	—	—	(4,109)	(4,109)
Balance, December 31, 2009	180,088	667	1,359	9,596	(25,105)	(40,893)	125,712
Unit-based compensation related to options	—	—	15	—	—	—	15
Exchange of units	460	(460)	—	—	—	—	—
Net loss	—	—	—	—	(19,907)	—	(19,907)
Balance, December 31, 2010	180,548	207	1,374	9,596	(45,012)	(40,893)	105,820

Holloway Lodging Real Estate Investment Trust

Consolidated Statement of Operations and Comprehensive Loss For the years ended December 31, 2010 and 2009

(in thousands of dollars except per unit amounts)

	2010 \$	2009 \$
Hotel revenues		
Rooms	63,174	61,837
Other	10,277	10,148
	<hr/> 73,451	<hr/> 71,985
Hotel expenses		
Operating expenses	47,696	46,236
Property taxes and insurance	4,657	4,627
Management fees	1,818	1,810
	<hr/> 54,171	<hr/> 52,673
Hotel operating income	<hr/> 19,280	<hr/> 19,312
Other (income) expenses		
Interest on mortgages and other debt	10,826	10,997
Interest on convertible debentures	4,989	4,989
Accretion on convertible debentures, mortgages and deferred financing fees	3,093	2,578
Corporate and administrative	2,880	2,173
Interest income	(213)	(739)
Unrealized foreign exchange gain	(242)	(737)
Depreciation and amortization	12,986	12,969
Loss on acquisition or disposal	193	-
Provision for impairment of mezzanine loans and advances	-	11,059
Provision for impairment of investments in hotel properties	423	1,011
Provision for impairment of hotel property	6,768	-
	<hr/> 41,703	<hr/> 44,300
Loss before income taxes from continuing operations	(22,423)	(24,988)
Recovery of future income taxes (note 21)	<hr/> (2,516)	<hr/> (3,056)
Loss from continuing operations	(19,907)	(21,932)
Income from discontinued operations (note 15)	<hr/> -	<hr/> 1,595
Net loss and comprehensive loss for the years	<hr/> (19,907)	<hr/> (20,337)
Basic and diluted earnings (loss) per unit (note 13)		
- from continuing operations	(0.51)	(0.56)
- from discontinued operations	-	0.04

Holloway Lodging Real Estate Investment Trust

Consolidated Statement of Cash Flows

For the years ended December 31, 2010 and 2009

(in thousands of dollars)

	2010 \$	2009 \$
Cash provided by (used in)		
Operating activities		
Net loss and comprehensive loss from continuing operations for the years	(19,907)	(21,932)
Charges (credits) to income not involving cash (note 14)	20,720	23,888
	813	1,956
Net change in non-cash working capital balances related to operations (note 14)	1,988	(2,719)
Cash flow from discontinued operations	49	1,120
Cash flow from operating activities	2,850	357
Investing activities		
Decrease in restricted cash	9	93
Increase in capital reserves	(758)	(1,746)
Issuance of mezzanine loans and advances	–	(885)
Proceeds from repayment of mezzanine loan	–	3,000
Proceeds from sale of (increase in) investments in hotel properties	271	(283)
Additions to property and equipment and other assets, continuing operations	(3,594)	(1,545)
Proceeds from sale of property, discontinued operations	–	15,636
Cash flow from (used in) investing activities	(4,072)	14,270
Financing activities		
Increase in line of credit	2,519	–
Repayment of capital lease obligations	(285)	(350)
Proceeds from mortgages and loans, net of deferred financing fees	10,120	1,040
Repayment of mortgages and loans payable, continuing operations	(13,849)	(4,589)
Repayment of promissory notes	(239)	–
Distributions paid to unitholders	–	(4,794)
Repayment of mortgages and capital leases, discontinued operations	–	(7,140)
Cash flow used in financing activities	(1,734)	(15,833)
Net change in cash and cash equivalents during the years	(2,956)	(1,206)
Cash and cash equivalents, continuing operations – Beginning of years	3,756	4,860
Cash and cash equivalents, discontinued operations – Beginning of years	30	132
	3,786	4,992
Cash and cash equivalents, continuing operations – End of years	830	3,756
Cash and cash equivalents, discontinued operations – End of years	–	30
	830	3,786

Supplemental cash flow information (note 14)

Holloway Lodging Real Estate Investment Trust

Notes to Consolidated Financial Statements

For the years ended December 31, 2010 and 2009

(all dollar amounts are in thousands, except per unit amounts)

1 Basis of presentation and nature of operations

Holloway Lodging Real Estate Investment Trust (“Holloway Lodging REIT” or the “REIT”) is an open-ended real estate investment trust that was formed under the laws of the Province of Ontario pursuant to its Declaration of Trust on March 28, 2006.

The objectives of the REIT are: (a) to expand its asset base and increase its funds from operations through accretive acquisitions and internal growth initiatives; (b) to enhance the value of its assets to maximize long-term unit value through active management of its assets; and (c) to increase cash flow from operations in order to resume distributions to unitholders at the appropriate time.

As at December 31, 2010, the REIT owned 21 hotels in Canada and 1 hotel in the United States with 2,386 guest rooms and suites and held minority ownership interests in six other hotels.

2 Significant accounting policies

The consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles (“GAAP”) and reflect the following policies:

a) Consolidation

The consolidated financial statements include the accounts of the REIT and its wholly-owned subsidiaries, Holloway Lodging Limited Partnership, Holloway Lodging II Limited Partnership, HL Trust, HL General Partner Inc., Holloway Lodging Canada, Inc., Holloway Lodging US, Inc., HL US General Partner, Inc. and HL (1290 Paradise Circle) US LP. Any reference to the “REIT” throughout these consolidated financial statements refers to the REIT and its subsidiaries. All transactions between the REIT and its subsidiaries have been eliminated.

b) Cash and cash equivalents

Cash and cash equivalents include cash on hand, balances with banks and highly liquid temporary investments with original maturities of three months or less.

c) Inventories

Inventories consist of linen, food, beverages and other supplies. Inventories are valued at the lower of cost and net realizable value. Cost is determined on a first-in, first-out basis.

d) Capital reserve

The capital reserve account represents funds held by mortgagors or funds internally restricted for improvements to the properties.

e) Investments in hotel properties

The investments in hotel properties represent equity ownership interests in six hotel partnerships or co-tenancies ranging from 2.52% to 19.06%. The investments are accounted for using the cost method. When there has been a loss in value that is other than a temporary decline, an impairment loss is recognized.

Holloway Lodging Real Estate Investment Trust

Notes to Consolidated Financial Statements

For the years ended December 31, 2010 and 2009

(all dollar amounts are in thousands, except per unit amounts)

2 Significant accounting policies (continued)

f) Property and equipment

Property and equipment, including land, buildings, furniture, fixtures and equipment, are stated at cost less accumulated amortization or estimated net recoverable amount, adjusted for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable.

Amortization is provided on a straight-line basis at rates designed to write-off the assets over their estimated economic lives as follows:

Land lease	Term of the lease
Buildings	40 years
Furniture, fixtures and equipment	7 years
Paving	10 years
Signage	10 years
Landscaping	5 years
Computer equipment	3 years
Vehicles	3 years

g) Impairment of long-lived assets

The REIT's long-lived assets, consisting of property and equipment, are reviewed for impairment whenever events or changes in circumstances indicate the carrying amount of an asset might not be recoverable. Long-lived assets are reviewed at the individual property level, the lowest level for which identifiable cash flows are largely independent, when testing for and measuring impairment. A two-step process is used to assess the impairment of long-lived assets held for use, with the first step determining when impairment is recognized and the second step measuring the amount of the impairment. Impairment losses are recognized when the carrying amount of long-lived assets exceeds the sum of the undiscounted cash flows expected to result from their use and eventual disposition and are measured as the amount by which the long-lived asset's carrying amount exceeds its fair value.

h) Impairment of loans receivable

Loans receivable are classified as impaired when, in the opinion of management, there is a reasonable doubt as to the timely collection of principal, interest and the underlying security of the loan. The carrying amount of a loan receivable classified as impaired is reduced to its estimated fair value.

i) Other assets

Other assets consist of franchise fees and other agreements. Application and initial franchise fees are amortized on a straight-line basis over the term of the franchise agreement and the amortization is included in depreciation and amortization in these consolidated financial statements. The Non-competition, Right of First Opportunity and Participation Agreement (note 15) is amortized on a straight-line basis over the five-year term of the agreement.

Holloway Lodging Real Estate Investment Trust

Notes to Consolidated Financial Statements

For the years ended December 31, 2010 and 2009

(all dollar amounts are in thousands, except per unit amounts)

2 Significant accounting policies (continued)

j) Leases

Leases entered into by the REIT in which substantially all of the benefits and risks of ownership are transferred to the REIT are recorded as capital leases and classified as property and equipment and obligations under capital leases. Obligations under capital leases reflect the present value of future lease payments, discounted at an appropriate interest rate and are reduced by lease payments net of imputed interest. Assets under capital leases are amortized based on the estimated useful life of the asset. All other leases are classified as operating leases and lease payments are expensed in the period in which they are incurred.

k) Revenue recognition

Revenues are generated primarily from room occupancy, food and beverage services and parking. Revenues are recognized when the services are provided and collection is reasonably assured.

l) Income taxes

Under the provisions of Bill C-52, Budget Implementation Act, 2007, which was substantively enacted on June 12, 2007, the REIT, as a publicly traded income trust, is considered a specified investment flow-through (“SIFT”). As the REIT has exceeded the “normal growth” rates as defined in the guidelines issued by the Department of Finance, the REIT became subject to tax in 2007.

The REIT uses the asset and liability method of accounting for income taxes. Under the asset and liability method, future tax assets and liabilities are recognized for the 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 year the date of enactment or substantive enactment is expected.

Certain of the REIT's subsidiaries are corporations and are subject to income taxes. These subsidiaries use the liability method to account for income taxes, under which future income tax assets and liabilities are determined based on the differences between the financial reporting and tax bases of assets and liabilities, and are measured using the substantively enacted income tax rates and laws that are expected to be in effect in the years in which the future income tax assets or liabilities are expected to be settled or realized. The effect of changes in income tax rates on future income tax assets and liabilities is recognized in the period in which the change occurs. Valuation allowances are recorded unless it is more likely than not that a future income tax asset will be realized.

Holloway Lodging Real Estate Investment Trust

Notes to Consolidated Financial Statements

For the years ended December 31, 2010 and 2009

(all dollar amounts are in thousands, except per unit amounts)

2 Significant accounting policies (continued)

m) Earnings per unit

Basic earnings per unit are computed based on the weighted average number of units outstanding during the reporting period. The REIT follows the treasury stock method in computing diluted earnings per unit.

n) Unit repurchases

If the REIT repurchases its own units as the result of a unit buy-back, those units are deducted from equity and the associated units are cancelled. No gain or loss is recognized and the consideration paid including any directly attributable incremental costs is recognized directly in unitholders' equity.

o) Unit-based compensation

The REIT accounts for unit options issued under its unit option plan using the fair value method. Under this method, compensation expense is measured at fair value at the grant date using the Black-Scholes option pricing model and is recognized over the vesting period. Option pricing models require the input of highly subjective assumptions including the expected volatility. Changes in the assumptions can materially affect the fair value estimate, and therefore, the existing models do not necessarily provide a reliable measure of the fair value of the REIT's unit options.

The REIT recognizes all other unit-based payments to employees or trustees, including the issuance of units as compensation, at the fair market value of the units on the date of issuance.

Holloway Lodging Real Estate Investment Trust

Notes to Consolidated Financial Statements

For the years ended December 31, 2010 and 2009

(all dollar amounts are in thousands, except per unit amounts)

2 Significant accounting policies (continued)

p) Financial instruments

i) Financial instruments – recognition and measurement

Section 3855 establishes standards for recognizing and measuring financial assets, financial liabilities and non-financial derivatives. All financial instruments are required to be measured at fair value on initial recognition, except for certain related party transactions. Measurement in subsequent periods depends on whether the financial instrument has been classified as held-for-trading, available-for-sale, held-to-maturity, loans and receivables, or other liabilities.

The REIT has implemented the following classifications:

- Cash and cash equivalents are classified as “Financial Assets Held-for-Trading”. These financial assets are marked-to-market through net income at each period end.
- Accounts receivable, loans receivable from related parties and are classified as “Loans and Receivables”. After their initial fair value measurement, they are measured at amortized cost including transaction costs using the effective interest method.
- Accounts payable, capital leases, convertible debentures, mortgages and loans payable and promissory notes payable are classified as “Other Financial Liabilities”. After their initial fair value measurement, they are measured at amortized cost net of transaction costs using the effective interest method.

ii) Comprehensive income

Under Section 1530, comprehensive income is comprised of net earnings and other comprehensive income (“OCI”) which generally would include unrealized gains and losses on financial assets classified as available-for-sale, unrealized foreign currency translation adjustments, net of hedging, arising from self-sustaining foreign operations and changes in the fair value of the effective portion of cash flow hedging instruments. The REIT has no OCI, and therefore, accumulated OCI is not presented as a category of unitholders’ equity.

q) Management estimates

The presentation of financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingencies at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Significant estimates are required in the determination of future cash flows and probabilities in assessing the recoverability of hotel properties and other long-term assets, the valuation of loans receivable, the determination of useful lives for depreciation and amortization purposes, the fair value of financial instruments for disclosure purposes, the value of conversion options in convertible debentures, the value of unit options and the determination of future income tax assets and liabilities. Actual results could differ from these estimates.

Holloway Lodging Real Estate Investment Trust

Notes to Consolidated Financial Statements

For the years ended December 31, 2010 and 2009

(all dollar amounts are in thousands, except per unit amounts)

2 Significant accounting policies (continued)

r) Foreign currency translation

Monetary assets and liabilities of integrated foreign operations are translated into Canadian dollars at the rate of exchange in effect at the balance sheet date. Other non-monetary assets and non-monetary liabilities are translated at rates of exchange in effect when the assets were acquired or liabilities incurred. Revenues and expenses are translated at the average monthly rates of exchange during the year and depreciation and amortization is translated at rates of exchange consistent with the assets to which they relate. Gains or losses on translation of integrated foreign operations are recognized in income.

Future changes to Canadian GAAP

The REIT will cease to prepare its consolidated financial statements in accordance with Canadian GAAP as set out in Part V of the CICA Handbook – Accounting (“Canadian GAAP”) for the year beginning on January 1, 2011 when it will start to apply International Financial Reporting Standards as published by the International Accounting Standards Board as set out in Part 1 of the CICA Handbook – Accounting as its primary basis of accounting. Consequently, future accounting changes to Canadian GAAP that are effective for periods beginning on or after January 1, 2011 are not discussed in these financial statements as they will not be applied by the REIT.

3 Loans receivable from related parties

The REIT has a \$6,239 (December 31, 2009 - \$6,350) loan receivable from Pacrim Hospitality Services Inc., a company in which a member of management and trustee has a significant ownership interest. The loan is unsecured, is due on February 1, 2018, is repayable at any time without penalty and bears interest at the lesser of 13% and the trailing three-month yield plus 1% on Holloway’s units. As the yield on Holloway’s units declined to 0% with the suspension of distributions, the interest rate is currently 1%.

During the second quarter of 2010, the loan was reduced by \$111 representing the unpaid remuneration for services rendered by Pacrim Hospitality Services Inc. to the Windsor Super 8 hotel and was applied against the principal balance of the loan when the hotel was acquired.

The REIT has a \$159 loan receivable due December 31, 2011 from Winport Developments Inc., a company in which a member of management and trustee has a significant ownership interest. The loan is secured by 55,555 units of the REIT and a guarantee by 3475425 Canada Inc., a company in which a member of management and trustee has a significant ownership interest, is repayable at any time without penalty and bears interest at 11% per annum.

Holloway Lodging Real Estate Investment Trust

Notes to Consolidated Financial Statements

For the years ended December 31, 2010 and 2009

(all dollar amounts are in thousands, except per unit amounts)

4 Acquisition of hotel property

During the second quarter of 2010, the REIT acquired the Super 8 hotel in Windsor, Nova Scotia. As Holloway had provided a \$1.9 million mezzanine loan to the hotel which was in default, the owners Winport Developments Limited Partnership, a related party, relinquished ownership to Holloway pursuant to a quit claim. Holloway assumed all the assets and liabilities of the hotel effective June 1, 2010. The excess of liabilities assumed over assets acquired of \$47 was recorded as a loss on acquisition of hotel property. The acquisition has been accounted for under the purchase method and accordingly, the results of the operations of the hotel since the date of acquisition have been included in the consolidated statement of income. The following table details the acquisition and how it was financed:

Location: Windsor, Nova Scotia

Date of Acquisition: June 1, 2010

	\$
Assets acquired	
Land	300
Building	2,400
Furniture, fixtures, equipment and other	340
Signage	10
Franchise fees	14
Other working capital and short-term liabilities assumed	<u>(277)</u>
	<u>2,787</u>
Financed by	
Assumed mortgage	2,834
Excess of liabilities over assets acquired	<u>(47)</u>
	<u>2,787</u>

5 Investments in hotel properties

On December 22, 2008, the REIT acquired beneficial equity ownership interests in a number of hotels located in Canada and an assignment of \$680 in cash proceeds from Winport Developments Limited Partnership, a related party, at the exchange amount of \$3,552. The equity ownership percentages range from 2.52% to 19.06%. The investments are accounted for using the cost method. As part of the transaction, Winport Developments Limited Partnership assigned its right to receive \$680 in proceeds from the sale of Winport Developments Limited Partnership's equity ownership interest in RegWin Hotel Partnership to the REIT. The \$680 was received on December 23, 2008. The cost of the investments has been reduced by \$183, representing the discount on one of the promissory notes used to finance the purchase of these investments (note 11).

During the year ended December 31, 2010, the REIT recorded a provision for impairment of \$423 against its investment in the Super 8 in Toronto, ON, which represents the total cost of this investment.

During the year ended December 31, 2009 the REIT recorded a provision for impairment of \$549 against its investment in the Super 8 in Langley, BC, which represents the total cost of this investment. In addition, the REIT wrote off its investment of \$462 in the Super 8 in Midland, ON, as it relinquished its ownership interest in this hotel.

Holloway Lodging Real Estate Investment Trust

Notes to Consolidated Financial Statements

For the years ended December 31, 2010 and 2009

(all dollar amounts are in thousands, except per unit amounts)

7 Other assets

	2010		
	Cost	Accumulated	Net
	\$	amortization	\$
		\$	
Agreements	500	349	151
Franchise fees	876	309	567
	<u>1,376</u>	<u>658</u>	<u>718</u>
			2009
	Cost	Accumulated	Net
	\$	amortization	\$
		\$	
Agreements	500	250	250
Franchise fees	854	227	627
	<u>1,354</u>	<u>477</u>	<u>877</u>

8 Line of credit

The REIT has two available lines of credit for \$5.0 million and \$0.5 million. As at December 31, 2010, the REIT had drawn \$2.5 million of the \$5.0 million line of credit. This line of credit bears interest at prime plus 2.5%, is payable on demand and is secured by a demand collateral mortgage and charge on the Holiday Inn Express in Kamloops, BC.

Holloway Lodging Real Estate Investment Trust

Notes to Consolidated Financial Statements

For the years ended December 31, 2010 and 2009

(all dollar amounts are in thousands, except per unit amounts)

9 Obligations under capital leases

The REIT assumed various capital lease obligations to acquire computer equipment, signage, furniture and hotel equipment.

	2010 \$	2009 \$
Present value of future minimum lease payments	222	507
Less: Current portion	132	285
	<u>90</u>	<u>222</u>

Estimated future repayments over the next five years are as follows:

	\$
Year ending December 31, 2011	147
2012	85
2013	10
2014	-
2015	-
Thereafter	<u>-</u>
Future minimum lease payments	242
Less: Amounts representing interest at a weighted average rate of 10.52%	<u>20</u>
Present value of future minimum lease payments	<u>222</u>

10 Mortgages and loans payable

	2010 \$	2009 \$
Mortgages payable, bearing interest at a weighted average rate of 6.75% (2009 - 6.82%) and maturing on various dates from June, 2011 to July, 2017. Individual first charges on most of the hotel properties have been pledged as security for individual mortgages	153,630	154,446
Other	4	39
	<u>153,634</u>	<u>154,485</u>
Less: Deferred financing fees	1,041	1,002
Less: Current portion	41,034	4,953
	<u>111,559</u>	<u>148,530</u>

Holloway Lodging Real Estate Investment Trust

Notes to Consolidated Financial Statements

For the years ended December 31, 2010 and 2009

(all dollar amounts are in thousands, except per unit amounts)

10 Mortgages and loans payable (continued)

Estimated future principal repayments over the next five years are as follows:

	\$
Year ending December 31, 2011	41,034
2012	11,244
2013	3,305
2014	3,533
2015	11,948
Thereafter	82,570

11 Promissory notes payable

On December 22, 2008, the REIT issued two promissory notes for \$3,000 and \$552, respectively, payable to Winport Developments Limited Partnership to finance the acquisition of the investments in hotel properties. The notes were assigned by Winport Developments Limited Partnership to its partners/owners. The partners include various Dynamic mutual funds, a Gluskin Sheff mutual fund, Canadian Mortgage Capital Corporation, Holloway Investments Inc., a related party and SLC Development Corporation, a related party. The \$3,000 promissory note bears interest at 6% per year until December 22, 2011 and 12% per year, thereafter. The \$552 note does not bear interest and therefore has been discounted by \$183, representing the net present value of the implicit interest. The discount is being accreted to interest expense over five years, the expected term of the promissory notes. The principal of the notes are repayable on the sale of Holloway's ownership interests or the sale of the underlying properties. During the year ended December 31, 2010, Holloway repaid \$239 on the promissory notes as a result of the sale of its interest in two hotels. The notes mature on December 22, 2011 at which time the REIT can pay all or a portion of the notes in cash or, by the issuance of units, or extend the term of either or both of the notes at its sole discretion. As the REIT can extend the term of the notes, they are presented as a long-term liability.

Holloway Lodging Real Estate Investment Trust

Notes to Consolidated Financial Statements

For the years ended December 31, 2010 and 2009

(all dollar amounts are in thousands, except per unit amounts)

12 Convertible debentures

On August 1, 2006, the REIT issued \$20,238 in convertible, redeemable debentures. The debentures bear interest at 8%, payable semi-annually on February 1st and August 1st and mature on August 1, 2011. The convertible debentures can be converted into units of the REIT at \$5.40 per unit at any time commencing two years and one day from the issuance date and ending on the date that is 15 days prior to the maturity date.

On June 21, 2007, the REIT issued \$45,000 in convertible, redeemable debentures. The debentures bear interest at 6.5%, payable semi-annually on June 30th and December 31st and mature on June 30, 2012. The convertible debentures can be converted into units of the REIT at \$6.15 per unit at any time commencing two years and one day from the issuance date and ending on the date that is 15 days prior to the maturity date. On July 18, 2007, the REIT issued an additional \$6,844 in convertible, redeemable debentures with the same terms as the June 21, 2007 debentures, pursuant to the underwriters exercising their over-allotment option.

Subject to various conditions and time frames, the REIT can redeem the debentures. In the event the REIT gives notice of redemption, the debentures holders have 30 days to elect to convert their debentures into units.

The REIT has the option to repay the principal amount of the 6.5% debentures, in whole or in part, at maturity, by issuing the number of units calculated by dividing the aggregate principal amount by 95% of the current market price of the units on the maturity date. This alternative does not exist with the 8% debentures.

The convertible debentures have been valued at their estimated fair value at the time of issuance, according to the terms and conditions in place at the time. The difference between the gross proceeds and the estimated fair value of the debt of \$5,300 on the August 1, 2006 8% debentures, \$4,150 on the June 21, 2007 6.5% debentures and \$644 on the July 18, 2007 6.5% debentures represents the value of the conversion feature of the debentures and accordingly, has been recorded as a component of equity. The difference between the recorded value of the debt component of the debentures and their face value has been accounted for as a discount on the issuance of the debt and is being accreted to interest expense, using the effective interest rate method, over the respective terms of the debentures.

The debt component of the convertible debentures is recorded as a liability. The accretion of the discount on the issuance of the debentures increases the debt component to their face value over the term of the debentures.

The REIT has a signed term sheet to finance the repayment of the debentures that mature on August 1, 2011.

	2010 \$	2009 \$
Debt component	61,988	61,988
Accretion of convertible debentures	7,515	5,295
Deferred financing fees	(768)	(1,348)
Current portion	(19,138)	—
	<u>49,597</u>	<u>65,935</u>

Holloway Lodging Real Estate Investment Trust

Notes to Consolidated Financial Statements

For the years ended December 31, 2010 and 2009

(all dollar amounts are in thousands, except per unit amounts)

13 Unitholders' equity

The REIT is authorized to issue an unlimited number of units ("REIT units") for the consideration of, and on the terms and conditions determined by, its Declaration of Trust. Each REIT unit is transferable and represents an equal undivided beneficial interest in any distribution from the REIT. All REIT units are of the same class and have equal rights and privileges.

Class B Limited Partnership units

The Class B Limited Partnership units ("exchangeable LP units") are exchangeable for units of the REIT on a one-for-one basis pursuant to an exchange agreement. Special voting units are also issued to the Class B LP holders such that the exchangeable LP units hold the economic and voting equivalent of the REIT units.

Issued and outstanding units

The following presents the number of units issued and outstanding, and the related ascribed values, for the years ended December 31, 2010 and 2009:

	Number of units issued and outstanding			Ascribed value \$		
	REIT Units	Class B LP Units	Total	REIT Units	Class B LP Units	Total
Balance, December 31, 2008	38,801,716	333,500	39,135,216	180,088	667	180,755
Balance, December 31, 2009	38,801,716	333,500	39,135,216	180,088	667	180,755
Exchange of Class B LP units for REIT units	230,000	(230,000)	—	460	(460)	—
Balance, December 31, 2010	39,031,716	103,500	39,135,216	180,548	207	180,755

Holloway Lodging Real Estate Investment Trust

Notes to Consolidated Financial Statements

For the years ended December 31, 2010 and 2009

(all dollar amounts are in thousands, except per unit amounts)

13 Unitholders' equity (continued)

Option activity for the years ended December 31, 2010 and 2009 was as follows:

	2010		2009	
	Number	Weighted average exercise price \$	Number	Weighted average exercise price \$
Outstanding, beginning of year	1,302,256	4.04	1,302,256	4.04
Forfeited	<u>(328,415)</u>	—	<u>—</u>	—
Outstanding, end of year	<u>973,841</u>	4.18	<u>1,302,256</u>	4.04

The following table summarizes information about options outstanding and exercisable at December 31, 2010:

Weighted average exercise price per unit \$	Number outstanding	Weighted average exercise price per unit \$	Weighted average remaining contractual life (years)	Number exercisable
1.00	79,999	1.00	0.1	79,999
4.88	581,666	4.88	1.1	581,666
3.69	<u>312,176</u>	3.69	2.2	<u>312,176</u>
	<u>973,841</u>			<u>973,841</u>

Weighted average number of units

The basic and diluted weighted average number of units outstanding was as follows:

	2010 (units)	2009 (units)
Basic	39,135,216	39,135,216
Diluted	39,135,216	39,135,216

Holloway Lodging Real Estate Investment Trust

Notes to Consolidated Financial Statements

For the years ended December 31, 2010 and 2009

(all dollar amounts are in thousands, except per unit amounts)

14 Supplemental cash flow information

Changes (credits) to income not involving cash:

	2010	2009
	\$	\$
Unit-based compensation	15	64
Depreciation and amortization	12,986	12,969
Accretion on convertible debentures, mortgages and deferred financing fees	3,093	2,578
Loss on acquisition or disposal	193	-
Provision for impairment of investments in hotel properties	423	1,011
Provision for impairment of mezzanine loans and advances	-	11,059
Provision for impairment of hotel property	6,768	-
Unrealized foreign exchange gain	(242)	(737)
Recovery of future income taxes	(2,516)	(3,056)
	<hr/>	<hr/>
	20,720	23,888
	<hr/>	<hr/>

Net change in non-cash working capital balances related to operations:

	2010	2009
	\$	\$
Accounts receivable	(525)	882
Inventories	19	21
Prepaid expenses and deposits	1,871	(2,271)
Accounts payable and accrued liabilities	623	(1,351)
	<hr/>	<hr/>
	1,988	(2,719)
	<hr/>	<hr/>

Cash and cash equivalents are comprised of the following:

	2010	2009
	\$	\$
Cash on hand and balances with banks	830	3,756
	<hr/>	<hr/>
	2010	2009
	\$	\$
Interest paid	15,746	16,077
	<hr/>	<hr/>

Holloway Lodging Real Estate Investment Trust

Notes to Consolidated Financial Statements

For the years ended December 31, 2010 and 2009

(all dollar amounts are in thousands, except per unit amounts)

15 Discontinued operations

On October 5, 2009, the REIT sold the Wingate by Wyndham in Calgary, AB (the “Wingate”) for total proceeds of \$16,500. The REIT recognized a gain on the sale of \$1,474. Accordingly, the operations of the Wingate have been included in discontinued operations on the consolidated statement of operations and comprehensive loss and are reflected as assets and liabilities of discontinued operations of the consolidated balance sheet.

Discontinued operations for the years ended December 31, 2010 and 2009 are as follows:

	Years ended	
	December 31, 2010 \$	December 31, 2009 \$
Hotel revenues	–	2,442
Hotel expenses	–	1,474
Hotel operating income	–	968
Interest on mortgages and other debt and accretion of deferred financing fees	–	273
Depreciation and amortization	–	320
Gain on sale of property	–	(1,474)
	–	(881)
Income before income taxes	–	1,849
Provision for future income taxes	–	254
Income from discontinued operations	–	1,595

Holloway Lodging Real Estate Investment Trust

Notes to Consolidated Financial Statements

For the years ended December 31, 2010 and 2009

(all dollar amounts are in thousands, except per unit amounts)

16 Agreements

Hotel Management Agreement

Pacrim Hospitality Services Inc.

On June 7, 2006, Holloway Lodging REIT entered into a long-term management agreement with Pacrim Hospitality Services Inc. ("PHSI"), a related party, to manage the hotels purchased by the REIT, with an initial term of ten years and an automatic renewal for successive five year terms commencing on the last day of the initial term. PHSI is entitled to a base management fee of 3% of gross hotel revenues, an incentive fee, a purchasing fee of 4% of the cost of exceptional operating supplies and furniture, fixtures and equipment, a construction fee of 3% of the cost of construction materials, labour and equipment in connection with any construction or capital expenditures and an accounting fee ranging from \$23 to \$34 per year per hotel depending on the size of the hotel when accounting services are provided by PHSI. In addition, Intergy, a division of PHSI, provides central reservation services for the REIT's hotels. A commission of 10% is paid on reservations made through Intergy.

On November 24, 2006, the parties entered into an amending agreement such that the initial term with respect to each hotel shall commence on the date on which the REIT acquires the hotel for a term of ten years and automatic renewals for successive five-year terms.

On June 22, 2007, the REIT entered into a management agreement with Pomeroy Hospitality Ltd. ("Pomeroy") to manage ten hotels purchased by the REIT, with a term of five years. On February 1, 2008, PHSI acquired management of ten of the REIT's hotel properties located in northern Alberta and British Columbia from Pomeroy. The REIT acquired the hotels (the "Pomeroy Hotels") from affiliates of Pomeroy in June, 2007. Under the terms of an agreement among the REIT, PHSI and Pomeroy, Pomeroy assigned its interest in the hotel management agreement between Pomeroy and the REIT to PHSI on February 1, 2008 in return for a \$6,350 one-time payment from PHSI. At the same time, the existing hotel management agreement between the REIT and PHSI was amended to include the Pomeroy Hotels. Among other things, the amended hotel management agreement between the REIT and PHSI provides that PHSI receive reimbursable expenses plus a base management fee for the Pomeroy Hotels that is significantly lower than the base management fee payable under the previous hotel management agreement with Pomeroy until the REIT generates distributable income that exceeds certain targets.

In order to facilitate the assignment, the REIT loaned PHSI the funds paid to Pomeroy in consideration of the assignment (note 3).

Upon certain change of control events, as set out in the Hotel Management Agreement, PHSI is entitled to terminate the entire Hotel Management Agreement upon 60 days prior written notice to Holloway Lodging Limited Partnership and the REIT and to receive a lump sum payment of \$1.5 million in connection with such termination, without detracting from any other remedies available to it under the terms of the Hotel Management Agreement. In addition, PHSI shall be entitled to receive a one-time fee in the amount of the aggregate outstanding principal and accrued and unpaid interest on the loan as of the termination date of the Hotel Management Agreement. Such fee shall be withheld by Holloway Lodging Limited Partnership and used directly to repay the loan in full.

Holloway Lodging Real Estate Investment Trust

Notes to Consolidated Financial Statements

For the years ended December 31, 2010 and 2009

(all dollar amounts are in thousands, except per unit amounts)

16 Agreements (continued)

Hotel Management Agreement (continued)

Pacrim Hospitality Services Inc. (continued)

On July 7, 2010, pursuant to the acquisition of the Super 8 hotel in Windsor, Nova Scotia (note 4), PHSI agreed to defer its management and accounting fees until June 30th of each calendar year. PHSI is entitled to receive a payment calculated as 3/5th of 50% of the hotel's "free cash flow" for the prior twelve months (thirteen months for 2010-2011). Free cash flow is defined as net operating income less first mortgage debt service and 3% of total revenues for reserve for replacement. The payment is due on or before July 25th of each year. Any unpaid balance of the fees will be applied against the principal balance of the loan receivable from PHSI (note 3). The terms of the agreement will be revisited annually before June 30th for the foregoing twelve months.

Non-competition, Right of First Opportunity and Participation Agreement

On June 22, 2007, Holloway Lodging REIT entered into a non-competition, right of first opportunity and participation agreement with Pomeroy Gold Ltd. The agreement has a five year term and provides for (a) limitations on the development of hotels within a defined area without the consent of each party to the agreement; (b) the right of first opportunity for Holloway to purchase certain hotels; and (c) the right for Holloway to invest in certain Pomeroy developments.

17 Commitments and contingencies

Lease revenue

The REIT is committed to lease space in some of its hotels to outside parties. The minimum annual revenue from future rentals is expected to be as follows:

	\$
For the year ending December 31, 2011	654
2012	582
2013	446
2014	339
2015	158

Holloway Lodging Real Estate Investment Trust

Notes to Consolidated Financial Statements

For the years ended December 31, 2010 and 2009

(all dollar amounts are in thousands, except per unit amounts)

17 Commitments and contingencies (continued)

Franchise agreements

The following fees are payable under the terms of the various franchise agreements covering certain of the hotel properties:

	As a % of gross room revenue
To Super 8 Motels, Inc.	
Royalty fee	5%
Marketing assessment	3%
To Holiday Hospitality Franchising Inc. Group	
Royalty fee	5% - 6%
Marketing assessment	1.5% - 2%
Reservation assessment	1%
To Radisson Hotels International, Inc.	
Royalty fee	4% - 5%
Marketing assessment	2%
Reservation assessment	2%
To Pomeroy Inn & Suites Inc.	
Royalty fee	5%
Marketing assessment	3%
To Best Western International, Inc.	
Annual dues	\$54

Operating leases

The REIT has various equipment operating leases at several properties.

Land lease

The REIT has a long-term ground lease on the 5 Calgary Downtown Suites and Spa Hotel ("5 Calgary"). The ground lease expires on June 24, 2064. The amount of the annual ground lease payment varies with gross revenues and expenses. The minimum ground lease payments are \$10 per month until June 24, 2015. For the two periods beginning June 24, 2015 and June 24, 2040, the minimum annual ground lease payment will be adjusted based on the fair market value of the related land, free and unencumbered on those dates. The REIT is required to pay an annual ground lease participation fee related to the ground lease for 5 Calgary, which is equal to 25% of 5 Calgary's annual gross revenue reduced by property tax expense, the minimum ground lease payments for the year and an allowable deduction of 20% of gross revenues. The total ground lease expense, including the minimum ground lease payments and the ground lease participation fee, recorded for 2010 and 2009 was \$1,887 and \$1,852, respectively.

Holloway Lodging Real Estate Investment Trust

Notes to Consolidated Financial Statements

For the years ended December 31, 2010 and 2009

(all dollar amounts are in thousands, except per unit amounts)

17 Commitments and contingencies (continued)

The minimum annual lease payments over the next five years are as follows:

	Operating leases \$	Land lease \$	Total \$
Year ending December 31, 2011	112	123	235
2012	45	123	168
2013	24	123	147
2014	20	123	143
2015	7	123	130

Contingencies

In the course of the REIT's ordinary activities, the REIT is involved in administrative proceedings, litigations and claims. The REIT believes that either there are valid defences to any actions or that the outcome will not have a material impact on the REIT's consolidated financial position or results of operations.

18 Related party transactions

The information below details the related party transactions not previously disclosed in these financial statements, including amounts received or receivable, paid or payable and year-end balances.

	2010 \$	2009 \$
Pacrim Hospitality Services Inc. (PHSI), a company in which a member of management and trustee has a significant ownership interest		
Hotel management, accounting and related fees	2,462	2,523
Head office rent and office operating expenses	112	108
Reimbursable expenses related to hotels managed under reduced fee	481	637
Reservation services commissions paid to Intergy, a division of PHSI	379	369
Interest income on loan receivable	63	618
Capital purchasing fees and project management fees capitalized to property and equipment	41	36
Distributions paid or payable on Class B limited partnership units	—	6
Included in accounts payable and accrued liabilities	270	261
Winport Developments Inc., a company in which a member of management and trustee has a significant ownership interest		
Interest income on loan	17	17
Included in accounts receivable	—	22
Superior Lodging Corp., a company in which a trustee is a member of management and has an ownership interest		
Royalty fees	459	482

Holloway Lodging Real Estate Investment Trust

Notes to Consolidated Financial Statements

For the years ended December 31, 2010 and 2009

(all dollar amounts are in thousands, except per unit amounts)

19 Capital management

The REIT defines capital as the aggregate of unitholders' equity and interest-bearing debt. The objectives of the REIT's capital management program are to maintain a level of capital that complies with the investment and debt restrictions according to the REIT's Declaration of Trust, complies with existing debt covenants, optimizes the cost of capital, funds its business strategies and builds long-term unitholder value.

In managing its capital structure, the REIT monitors performance throughout the year to ensure anticipated working capital requirements and capital expenditures are funded from operations, available cash on deposit and, where applicable, bank borrowings. The REIT will make adjustments to its capital structure to meet the objectives of the broader corporate strategy or in response to changes in economic conditions and risk. In order to maintain or adjust the capital structure, the REIT may issue debt and/or issue or redeem units.

The REIT monitors capital using the following financial metrics, including (but not limited to):

- a Debt Service coverage ratio defined as earnings before interest, income taxes, depreciation, amortization, non-cash accretion of deferred financing fees and unit-based compensation (Earnings base) to mortgages, loans, promissory notes and capital lease interest and principal payments (Debt Service); and
- a Debt to Gross Book Value ("Debt to GBV") ratio defined as mortgages and loans payable, obligations under capital leases, the face value of promissory notes and the face value of convertible debentures ("Debt") divided by total assets plus accumulated depreciation and amortization ("GBV"). The REIT's Declaration of Trust states that the REIT's debt to GBV ratio should not exceed 60%.

Holloway Lodging Real Estate Investment Trust

Notes to Consolidated Financial Statements

For the years ended December 31, 2010 and 2009

(all dollar amounts are in thousands, except per unit amounts)

19 Capital management (continued)

	2010 \$	2009 \$
Capital structure		
Line of credit	2,519	–
Obligations under capital leases	222	507
Mortgages and loans payable	152,593	153,483
Convertible debentures	68,735	65,935
Promissory notes	3,203	3,405
	<hr/>	<hr/>
Total debt	227,272	223,330
	<hr/>	<hr/>
Unitholders' equity	105,820	125,712
	<hr/>	<hr/>
Total capital	333,092	349,042
	<hr/>	<hr/>
Ratios		
Total debt	227,272	223,330
Adjustment of convertible debentures to face value	3,347	6,147
Adjustment of promissory notes to face value	109	146
	<hr/>	<hr/>
Debt	230,728	229,623
	<hr/>	<hr/>
Gross book value	396,639	393,025
	<hr/>	<hr/>
Debt to GBV	58.2%	58.4%
	<hr/>	<hr/>
	2010	2009
	\$	\$
	<hr/>	<hr/>
Earnings base	16,612	18,909
Debt service	20,994	21,520
Debt service ratio	0.79	0.88

The REIT is also subject to financial covenants on its mortgages and loans payable, which are measured on an annual basis and include customary terms and conditions for borrowings of this nature. These include the Debt Service ratio presented above. The REIT is in compliance with, or has obtained waivers for all of its financial covenants except one. One lender has not provided a waiver however, as a result of discussions with this lender, management believes the loans will not be called prior to maturity. The two mortgages with this lender, on hotels in Fort McMurray and Drayton Valley, are included in current liabilities and mature in October 2011 and January 2012.

Holloway Lodging Real Estate Investment Trust

Notes to Consolidated Financial Statements

For the years ended December 31, 2010 and 2009

(all dollar amounts are in thousands, except per unit amounts)

20 Financial instruments

i) Fair value of financial instruments

The REIT's financial instruments consist of cash and cash equivalents, restricted cash, accounts receivable, capital reserves, loans receivable from related parties, line of credit, accounts payable and accrued liabilities, accrued interest on convertible debentures, obligations under capital leases, mortgages and loans payable, promissory notes payable and convertible debentures. The REIT's cash and cash equivalents, restricted cash, accounts receivable, capital reserves, line of credit, accounts payable and accrued liabilities and accrued interest on convertible debentures are carried at amortized cost, which approximates fair value due to the immediate or short-term maturities of these financial instruments.

The fair value of the REIT's obligations under capital leases and mortgages and loans payable is based on discounted future cash flows using discount rates that reflect current market conditions for instruments with similar terms and risks. The fair values do not necessarily represent amounts the REIT might pay in actual market transactions. The fair value of the convertible debentures is the trading value at December 31, 2010 and 2009, respectively.

	<u>Carrying value</u>	<u>2010 Fair value</u>	<u>Carrying value</u>	<u>2009 Fair value</u>
	\$	\$	\$	\$
Held for trading (cash, restricted cash and capital reserves)	7,742	7,742	9,919	9,919
Loans and receivables (accounts receivable)	2,962	2,962	2,438	2,438
Other financial liabilities (accounts payable and accrued liabilities, and accrued interest on convertible debentures)	9,270	9,270	8,531	8,531
Line of credit	2,519	2,519	–	–
Obligations under capital leases	222	222	507	507
Mortgages and loans payable	152,593	150,318	153,483	152,929
Convertible debentures	78,331	50,775	75,531	44,254

Holloway Lodging Real Estate Investment Trust

Notes to Consolidated Financial Statements

For the years ended December 31, 2010 and 2009

(all dollar amounts are in thousands, except per unit amounts)

20 Financial instruments (continued)

i) Fair value of financial instruments (continued)

Fair value hierarchy

Financial instruments recorded at fair value on the balance sheet 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 observed in active markets for identical assets or liabilities.

Level 2: valuation techniques based on inputs that are quoted prices of similar instruments in active markets; quoted prices used in a valuation model that are observable for that instrument; and inputs that are derived principally from or corroborated by observable market data by correlation or other means.

Level 3: valuation techniques with significant unobservable market inputs.

A financial instrument is classified to the lowest level of the hierarchy for which a significant input has been considered in measuring fair value.

The following table presents the financial instruments recorded at the fair value in the consolidated balance sheets, classified using the fair value hierarchy described above:

	Level 1	Level 2	2010 Level 3	Level 1	Level 2	2009 Level 3
	\$	\$	\$	\$	\$	\$
Financial assets						
Cash and cash equivalents	830	—	—	3,756	—	—
Capital reserves	6,361	—	—	5,603	—	—
Restricted cash	551	—	—	560	—	—

ii) Risk management

The REIT, through its financial assets and liabilities, has exposure to the following risks from its use of financial instruments: interest rate risk, credit risk, liquidity risk and currency risk. Senior management is responsible for setting acceptable levels of risk and reviewing risk management activities as necessary.

a) Interest rate risk

The REIT is exposed to interest rate risk on its lending and borrowing activities. It manages its exposure to interest rate risk by using primarily fixed rate debt so cash flow is not impacted significantly by a change in interest rates. The REIT had \$8,905 maturing on April 1, 2010, which it re-financed on March 1, 2010 at a 6.6% interest rate. The weighted average interest rate on its mortgages payable is 6.75% (December 31, 2009 - 6.82%) with a weighted average maturity of 4.7 years (December 31, 2009 - 5.4 years).

Holloway Lodging Real Estate Investment Trust

Notes to Consolidated Financial Statements

For the years ended December 31, 2010 and 2009

(all dollar amounts are in thousands, except per unit amounts)

20 Financial instruments (continued)

a) Interest rate risk (continued)

The convertible debentures have a weighted average interest rate of 6.9% (December 31, 2009 - 6.9%) and a weighted average maturity of 1.2 years (December 31, 2009 - 2.2 years).

At December 31, 2010, the REIT had no long-term debt at floating rates. The REIT's lines of credit are at floating rates. For the year ended December 31, 2010, a 1% change in interest rates would change the net loss by \$3 (December 31, 2009 - \$nil).

b) Credit risk

In accordance with its investment policy, the REIT invests excess cash in Government of Canada treasury bills, short-term Canadian and provincial government debt, bankers' acceptance notes and term deposits of Schedule 1 Banks. The credit risk on cash and cash equivalents is limited because the counter-parties are governments and banks with high credit-ratings assigned by international credit-rating agencies.

The amount of accounts receivable disclosed in the balance sheet of \$2,962 is net of allowance for bad debts, estimated by management based on prior experience and their assessment of the current economic environment.

Historically, there have been no significant material collection issues and the REIT does not believe it is subject to any significant concentration of credit risk. The REIT assesses the credit worthiness of customers requesting credit and listings of accounts receivable are reviewed by management and discussed with operations personnel on a monthly basis.

The following table sets forth details of accounts receivable and related allowance for doubtful accounts:

	2010	2009
	\$	\$
Accounts receivable under 30 days aged	1,867	1,503
Accounts receivable over 30 days aged	1,178	1,065
Less: Allowance for doubtful accounts	(83)	(130)
	<hr/>	<hr/>
	2,962	2,438
	<hr/>	<hr/>

The REIT is exposed to credit risk on its loans receivable from related parties (note 4). Management reviews the results and cash flows of these entities on a monthly basis.

Holloway Lodging Real Estate Investment Trust

Notes to Consolidated Financial Statements

For the years ended December 31, 2010 and 2009

(all dollar amounts are in thousands, except per unit amounts)

20 Financial instruments (continued)

c) Currency risk

The REIT earns revenue and incurs expenses in U.S. and Canadian currency, and as such, is subject to fluctuations as a result of foreign exchange rate variation. The REIT manages its exposure to currency risk by billing for its services in the U.S. in the underlying currency related to the expenditure. As this natural hedging effectively matches the revenue and expenses, the REIT's management considers there to be little currency risk. However, a \$0.01 change in the US dollar exchange rate will change the unrealized foreign exchange gain or loss by \$43 (December 31, 2009 - \$44).

d) Liquidity risk

The REIT's objective is to have sufficient liquidity to meet liabilities when due, as well as to maintain compliance with liquidity covenants on financing agreements and its capital management requirements and objectives.

On July 21, 2009, the REIT suspended distributions in order to conserve cash and satisfy its operating obligations, including principal repayments on its mortgages and loans payable and obligations under capital leases. On March 1, 2010, the REIT re-financed two mortgages, totalling \$8,905, that were scheduled to mature on April 1, 2010. The REIT has \$25,377 in mortgages that mature in 2011. The REIT expects to refinance its maturing mortgages at similar or better terms with existing or other lenders.

The REIT has \$20,238 in convertible debentures that mature on August 1, 2011. The REIT has a signed term sheet to finance the repayment of the debentures. The Board and management continue to explore other alternatives to raise funds to repay the debenture holders which may include other debt financing, the sale of certain properties, or some combination thereof.

The REIT monitors and forecasts its cash balances and cash flows generated from operations to meet its required obligations. At December 31, 2010, the REIT had drawn \$2,519 (December 31, 2009 - \$nil) from its available lines of credit of \$5,500.

Based on overall cash generation capability and overall financial position, while there can be no assurance, management believes the REIT will be able to meet all financial obligations as they become due.

Holloway Lodging Real Estate Investment Trust

Notes to Consolidated Financial Statements

For the years ended December 31, 2010 and 2009

(all dollar amounts are in thousands, except per unit amounts)

21 Income taxes

The following table reconciles the expected income taxes payable (recoverable) at the statutory income tax rate to the amounts recognized in the consolidated statements of income and comprehensive income for the years ended December 31, 2010 and 2009:

	2010 \$	2009 \$
Income before income taxes, including discontinued operations	(22,423)	(23,139)
Income tax rate	34.0%	35.0%
	(7,624)	(8,099)
Non-deductible stock option expense	5	22
Non-deductible foreign exchange losses	(41)	(386)
Non-deductible unrealized impairments	511	2,132
Accretion of discount on convertible debentures	755	685
Impact of rate change, timing of reversals	712	651
Other permanent differences	62	124
Non-taxable portion of capital gain	(16)	(148)
Valuation allowance	3,120	2,217
	(2,516)	(2,802)

The tax effects of temporary differences that give rise to significant portions of the future income tax assets and future income tax liabilities at December 31, 2010 and 2009 that are expected to reverse in the future are presented below:

	2010 \$	2009 \$
Future income tax assets		
Unit issuance costs, financing fees and related	305	1,134
Tax losses carried forward	9,982	6,749
Property and equipment – differences in net book value and undepreciated capital cost	2,190	–
Other	197	144
Valuation allowance - losses	12,674	8,027
Future income tax liabilities		
Property and equipment – differences in net book value and undepreciated capital cost	–	1,009
Other	92	72
	92	1,081
	12,582	6,946
Less: Valuation allowance	(5,500)	(2,380)
Net future income tax asset	7,082	4,566

Holloway Lodging Real Estate Investment Trust

Notes to Consolidated Financial Statements

For the years ended December 31, 2010 and 2009

(all dollar amounts are in thousands, except per unit amounts)

21 Income taxes (continued)

	2010 \$	2009 \$
Recovery of future income taxes is comprised of:		
Future income taxes related to the changes in the taxation rate	(712)	(582)
Future income taxes related to income and permanent differences	(1,861)	(2,754)
Non-taxable foreign exchange translation loss	57	534
	<u>(2,516)</u>	<u>(2,802)</u>

22 Seasonality

Revenues from hotel operations tend to fluctuate throughout the year, with greater demand in the second and third quarters of the calendar year, due to higher leisure travel in the summer months. The first quarter revenues are usually the lowest, as leisure travel is lower during the winter. Certain of the REIT's hotels in Alberta and British Columbia generate higher revenues in the first quarter from oil and gas drilling activities.

23 Segmented information

In measuring performance, the REIT does not distinguish or group its operations on a geographic or any other basis and, accordingly, results have been aggregated into a single reportable segment.

Geographical information

	2010 \$	2009 \$
Revenues		
Canada	71,523	69,905
United States	1,928	2,080
	<u>73,451</u>	<u>71,985</u>
 Property and equipment		
Canada	304,602	318,316
United States	8,772	8,149
	<u>313,374</u>	<u>326,465</u>

