

One of the **virtues**
of the Internet is its ability
to be used as a
medium for commerce.

CORPORATE PROFILE

CRYPTOLOGIC INC. is a public company listed on the Canadian Dealing Network under the trading symbol CRYP.

CryptoLogic is an innovator in the rapidly growing Internet technology industry. The company is engaged in the further development of proprietary Internet applications that utilize real-time cryptographic technology previously developed by the company.

The cryptographic protocol enables secure and real-time Internet communications and commerce. The applications also allow individuals and organizations to execute secure financial transactions across the Internet, in order to facilitate the buying and selling of merchandise, the distribution of software and information, and to securely transmit information including: electronic mail documents and data files.

In conjunction with the aforementioned, CryptoLogic has developed, released and is currently operating an Electronic cash application that allows users to transfer and store E-cash in a secure environment. CryptoLogic has also developed, released and is currently licensing on-line casino gaming software that allows users to play games of chance over the internet in real-time.

Through its wholly-owned subsidiary, the company licenses out its proprietary casino gaming software, and has subsequently realized significant licensing revenues.

As the Internet expands, there is a growing need for security in the areas of **commerce** and information exchange.

LETTER TO THE SHAREHOLDERS

Our talented team along with our innovative applications have produced exceptional results for 1997, our first full year of commercial operations. In 1997, we realized on our vision and took a leadership role in the Internet transaction processing industry. Since inception, the Company's technology has been utilized to process more than 100 million individual secure electronic transactions worth more than a billion dollars. CryptoLogic's Electronic Commerce technology has proven to be successful in reducing Internet fraud and transaction cost. Also, CryptoLogic's Internet gaming technology has become the most widely used Internet gaming platform.

Our technology and brands have become important assets and are now recognized throughout the world. They are being used by more than 200,000 people in over 200 countries. While CryptoLogic's software products forge ahead on a global scale, they have also won critical acclaim and awards including: TUCOW's highest rating, PCComputing's Green Light, RGT's highest rating and Pitboss.com's highest rating. The Company and its software products have also been featured in print media including PCGamer Magazine, PCComputing Magazine, the Wall Street Journal, the Globe and Mail and Canadian Business Magazine; along with television programs including Inside Edition, NHK Beyond 2000 and CNBC.

Despite accelerated growth in transaction processing in 1997, we continue to meet initial objectives of settling Internet transactions with high levels of security, reliability and speed while minimizing overall transaction cost.

OVERVIEW

We are pleased to report on our strong financial performance in 1997, and on several important accomplishments for the year, which we believe considerably strengthen CryptoLogic's position. In 1997 gross revenue exceeded our expectations at \$17.8 million, up from \$0.2 million in 1996. Similar performance was achieved in earnings, with earnings totaling \$12.8 million before unusual items (\$8.7 million after unusual items) up from a loss of \$0.6 million in 1996. Earnings per share in 1997 were \$1.27 (\$0.61 fully diluted) compared with a loss of \$0.12 (\$0.11 fully diluted) in 1996. Cash and short term assets increased by more than 1200% during 1997, from \$0.7 million to \$9.4 million, enabling the company to complete several new processing contracts with financial institutions; eliminating our reliance on third party processors and positioning the Company for further growth in 1998 and beyond. During 1997 we successfully licensed our Internet gaming technology to 6 additional licensees, this combined with 3 additional licensees in 1998 brings the total number of licensees to 10. Our financial performance during 1997 has qualified the company to apply for listing on the Toronto Stock Exchange, for which shareholder approval was granted in February 1998.

We concentrate our efforts
on remaining at the forefront of
real-time communications.

PRODUCT DEVELOPMENT

In late 1996 CryptoLogic commercially released its client/server Internet gaming technology and became the first company to deploy such technology — effectively creating a new industry. While there are many new entrants in this growing market, CryptoLogic's technology continues to be the most widely used in this industry. Looking forward, the company plans to release version 3.0, the next generation of its gaming technology, in mid 1998. By adding substantially to the functionality of the software, expanding its distribution channels and by changing the way in which the users "interface" with the software we hope to increase our market share and continue to be the industry's leading software supplier. Just as the company's software technology created the industry in 1996, and allowed it to flourish in 1997, in 1998 we will re-invent the industry yet again.

CryptoLogic's Electronic Commerce technology has also been commercially operating since late 1996. Throughout 1997, the technology has operated with high security, reliability and speed while maintaining low fraud and transaction cost. In 1998, we will build on this technology and add revolutionary new functionality, which we believe, will change the way people use the Internet. The technology allows for the secure settlement of micro-transactions and will enable a wide range of content and services that are currently not available because of the cost and accessibility of other payment mechanisms. The software will allow Internet merchants to dramatically expand the content and services provided to their customers by utilizing a new business model that allows for greater 'per delivery' revenue than is possible with the current advertising based model. We have recently completed a successful pilot of this software and will commence marketing activity in mid 1998.

CONCLUSION

1997 was an outstanding year for CryptoLogic. The Company proved its ability to develop world class software for the fast paced Internet market. Unlike most other industries and moreover, unlike most other decades, the Internet Industry in the 90's is one where companies need to become more competitive than ever. We recognize that there is little value in reflecting on where we have come, instead, we are focused on where we are going. CryptoLogic will continue to concentrate its resources on developing innovative software for Electronic Commerce. We believe this emerging industry represents a major growth opportunity. Our technology is uniquely suited to it, we have a proven track record and we intend to maintain our leadership.

Our most valuable asset continues to be our talented and determined team of employees, who have risen to the challenge of producing world-leading software and recognize we work in a highly competitive ever-changing industry. I would like to take this opportunity to acknowledge their valuable contributions as well as those made by management and the Board. I am confident that continued dedication will bring future success and new rewards for CryptoLogic and its shareholders in 1998.

Sincerely,



Andrew Rivkin
President and Chief Executive Officer



Mark Rivkin
Executive Vice President
and Chief Operating Officer

MANAGEMENT

THE EXECUTIVE TEAM

Andrew Rivkin

President, C.E.O. & Director

Mr. Rivkin co-founded CryptoLogic Inc. in February 1995 for the purposes of developing Internet software according to design principles previously established by the founders. Mr. Rivkin has significant Internet software expertise in the areas of: communications, security, and distributed system design. Previously Mr. Rivkin was President of Minds/Matter a computer consulting firm specializing in network business systems.

Mark Rivkin

Executive Vice President, Secretary & Director

Mr. Rivkin co-founded CryptoLogic Inc. in February 1995. Mr. Rivkin has significant software expertise in the areas of: system design, multimedia, graphics and marketing. As well as, extensive knowledge of the electronic entertainment industry. Previously Mr. Rivkin was President of Campus Notes a business which operated on four major University campuses.

Anatoly Plotkine

Vice President of Technology

Dr. Plotkine has a Ph.D. in Mathematics, and has twenty years of experience in software development. He has published a total of forty-three papers, eleven of which have been translated into English. While in Russia, he specialized in designing algorithms for real time data processing under contract with the military. For the last four years Dr. Plotkine worked with Russia's largest Internet Service Provider, designing Internet client/server applications. Dr. Plotkine has been working with CryptoLogic since August 1995.

Jenny Solursh

Vice President, Marketing & Communications

Ms. Solursh joined the CryptoLogic management team in March of 1996. She brings to the company significant Internet and related marketing experience, as well as extensive knowledge of global Internet marketing strategies. Ms. Solursh plays a key role and is responsible for corporate communications and investor relations.

Lisa Stevenson

Controller

Ms. Stevenson is a Chartered Accountant, who has obtained a Bachelor of Business Management, specializing in Accounting and Finance, and a Master of Business Administration with a focus in international trade. Ms. Stevenson gained significant experience in the mutual fund, banking and insurance industries while at one of the big six accounting firms in Toronto. Ms. Stevenson joined the CryptoLogic management team in January 1997.

Our ability to create opportunity on
the Internet is unlimited.

THE DEVELOPMENT TEAM

The development team with 14 permanent members and 3 consultants has considerable experience in the areas of; Internet Software Development, Security, Banking, and Client Server Applications. The Senior members of the development team are highlighted below:

Senior Developer of Server Applications

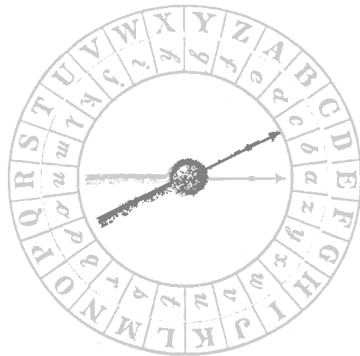
has a Ph.D. in Computer Science from the Institute of Cybernetics Research in Russia, specializing in UNIX programming and has an in-depth knowledge of this operating system. Previously he worked for the largest super-computer research facility in Russia designing UNIX applications.

Senior Developer of Client Applications

has a Ph.D. in mathematics and has developed many client/server applications for one of the largest banks in Russia. Previously he worked with defense contractors in Russia developing algorithms and has published twenty-six papers.

Consultants

Each of the external technology consultants has a Ph.D. in mathematics and experience developing data security systems including both symmetric and asymmetric algorithms for various military organizations and governments. The company's Gaming consultant is a Professor of mathematics and game theory at Princeton University and has published papers in six different languages on the theory of games.



MANAGEMENT'S DISCUSSION AND ANALYSIS

INTRODUCTION

The audited financial statements and accompanying notes reflect the year ended December 31, 1997 with 1996 comparison and should be read in conjunction with this analysis. It should be noted that the comparative information is for the period March 7, 1996 to December 31, 1996. During this period the business was in development stage with active commercial revenue commencing November 18, 1996. In this section, CryptoLogic and the Company refers to the consolidated operations of CryptoLogic Inc. and its wholly owned subsidiaries.

CryptoLogic Inc. is a software development company with leading proprietary technology enabling secure, high-speed financial transactions over the Internet. CryptoLogic has also developed proprietary software technology for the Internet Gaming industry. The Company has licensed its software products to companies internationally who hold valid gaming licenses. At December 31, CryptoLogic had completed seven licensing agreements.

OPERATIONS

In 1997, CryptoLogic entered into 6 licensing agreements, bringing the total number of licenses to seven. From November 1996 to December 1997 period, CryptoLogic's unique, proven server technology processed more than \$550 US million worth of electronic commerce transactions, realizing an extraordinarily low fraud rate of 1%. This compares to the average fraud rate for comparable industries of 2% to 3%.

In 1997, CryptoLogic made significant progress in strengthening its position in Internet financial processing industry and in improving its operations to manage the strong growth of its proprietary technologies and systems. The Company completed credit card processing contracts with a number of major financial institutions. This will enable CryptoLogic to effectively manage the steady growth and demand for financial transaction processing over the Internet.

RESULTS OF OPERATIONS

For the year 1997, revenue and earnings exceeded Company forecasts. Consolidated gross revenue for 1997 totaled \$17.8 million, up from \$0.2 million in 1996. Earnings totaled \$8.7 million compared with a loss of (\$0.6) million in 1996.

On November 18, 1996, CryptoLogic commercially released its Internet electronic commerce and Internet Gaming software application. It should be noted that during 1996, the Company generated revenue for only the last month and a half of 1996; thus year-over-year results are not comparable.

The majority of CryptoLogic's revenue is earned from the licensing of its software. In 1997, licensing fee revenue was \$17.7 million compared to \$0.2 million in 1996. The costs directly associated with the development and support of the software totaled \$4.1 million in 1997 and \$0.6 million in 1996.

Income taxes for the year ended December 31, 1997 were \$0.3 million, representing an effective tax rate of 3.5%. The effective tax rate differs from the Canadian statutory rates due to lower tax rates of foreign subsidiaries and utilization of losses carried forward from 1996.

Earnings per share were \$1.27 in 1997 compared to a loss of (\$0.12) in 1996. Fully diluted earnings per share for 1997 were \$0.61 compared to a loss of (\$0.11) in 1996. Earnings before unusual items were \$12.8 million or \$1.85 per share compared to \$1.27 per share after unusual items. Fully diluted earnings per share were \$0.88 before unusual items compared to \$0.61 after unusual items. Earnings per share have been calculated by the weighted average number of shares outstanding during the year.

UNUSUAL ITEMS

In accordance with established conservative and prudent corporate accounting policies, CryptoLogic took a one-time write-down against a single receivable of \$3.5 million, reducing final net earnings from \$12.8 million to \$8.7 million for the year. CryptoLogic is finalizing a security agreement, with the expectation of recovering the write-down.

In December 1997, CryptoLogic was successful in obtaining a favourable settlement to a legal dispute relating to the Class A common share purchase warrant, which was subsequently approved by shareholders. The warrant was amended and now entitles the holder to purchase, upon payment of \$0.50 per share, up to 5.8 million common shares in the capital of CryptoLogic (see note 4 to the consolidated financial statements of this Annual Report). Professional costs related to this legal action resulted in a charge of approximately \$0.56 million against revenues. There was no other litigation outstanding at December 31, 1997.

FINANCIAL CONDITION

CryptoLogic generated \$7.1 million in cash flow from operations in 1997 compared to negative cash flow from operations of (\$0.4) million in 1996. The positive cash flow from operations reflects the change from development work in 1996 to active commercial operations in 1997. CryptoLogic generated \$1.9 million in cash from financing activities through the issuance of capital stock by way of options and warrants in 1997 compared to \$0.8 million in 1996. CryptoLogic had capital asset expenditures of \$0.3 million in 1997 compared to \$0.09 million in 1996.

CryptoLogic's policy is to maintain sufficient funds in reserve to pay electronic commerce customers balances and vendors on a current basis. At December 31, 1997, CryptoLogic had sufficient cash and short-term investment balances to cover all liabilities. Cash and short-term investments at December 31, 1997 were \$9.4 million, an increase of \$8.7 million from 1996's level of \$0.7 million. The net current assets were \$10.9 million at December 31, 1997 compared to \$0.5 million at December 31, 1996. CryptoLogic has no loans outstanding and does not foresee the need for borrowing in the near future.

CryptoLogic is required to maintain a percentage of credit card processing levels as reserves with the processors. At December 31, 1997, reserves and deposits with credit card processors totaled \$3.1 million.

Amounts held on deposit with CryptoLogic from electronic commerce customers is disclosed as a liability on the balance sheet entitled Funds held on deposit. At December 31, 1997, the amount of funds held on deposit equaled \$0.8 million up from \$0.06 million at the end of 1996.

RISKS AND UNCERTAINTIES

Legal Status of Internet Gambling: There is uncertainty as to the legal status of gaming over the Internet. This uncertainty could potentially effect CryptoLogic's licensees and in turn the Company. The licensees of CryptoLogic's gaming software are all legally licensed in various jurisdictions to allow casino games to be played over the Internet.

Presently, the United States Congress is considering the Internet Gambling Prohibition Act (Kyl Bill), which would amend the Interstate Wire Act, so that persons engaged in the United States in the business of betting or wagering and the casual bettor, who knowingly use a communication facility for betting or gambling could be fined or imprisoned. Internet service providers would be required to block out gambling sites and would be subject to state and federal authority.

A coalition of interest groups, who believe it is unconstitutional are against this bill, as well as, Internet service providers who object to being regulated in this fashion.

In addition to the legalized licensed gaming over the Internet permitted by various Caribbean governments, on March 18, 1998, the Australian State of Queensland passed legislation permitting licensed cybergambling. The other states in Australia and New Zealand are also close to legalizing Internet gambling.

It is unclear at this time how the uncertainty to the legal status of gaming will effect CryptoLogic's licensees and CryptoLogic's licensing revenue.

Foreign exchange (gain)/loss: CryptoLogic's financial statements are reported in Canadian dollars and are subject to fluctuations in the rates of exchange with the currencies of the countries in which the Corporation and subsidiaries operate. During 1997, CryptoLogic reported a foreign exchange gain of \$0.2 million. There may be a need in the future to hedge currency exposure.

Competitive risks: CryptoLogic transacts business in the highly competitive fields of electronic commerce and casino software. In addition to the seven casinos licensed to use CryptoLogic's software, there are approximately 45 additional active online casinos. There have been predictions that Internet gaming could be \$8-\$10 billion per annum industry by the Year 2000. In the development of the casino software, CryptoLogic strives to produce software with the latest graphic interface. The competitive risks faced by CryptoLogic are no different than that of our competitors.

Technological Risks: The electronic commerce industry is growing rapidly and is continuously incorporating technological advancements into the development of software to achieve high level of security while improving electronic commerce reliability and functionality. CryptoLogic is up-to-date on the advancements in this area and is improving the software and systems where required to keep CryptoLogic's security and reliability protocol in the forefront of the industry.

Dependence on Key Personnel: The highly competitive market for qualified software developers could adversely effect CryptoLogic's ability to retain qualified personnel. CryptoLogic believes that its employment policies in this regard are competitive within the industry.

Year 2000: The Year 2000 issue is the result of computer programs being written using two digits rather than four to define the applicable year. CryptoLogic has been actively working towards resolving any issues relating to Year 2000 compliance and will be fully compliant by the Year 2000. There is no guarantee that CryptoLogic's credit card processors will be Year 2000 compliant. The cost to change the current systems to achieve Year 2000 compliance is not material.

OUTLOOK

Management remains committed to building shareholder value through long-term growth in revenues and profits. Going forward, CryptoLogic will continue to focus its resources on electronic commerce. The electronic commerce industry is beginning to evolve, and it will be a major market by all projections.

MANAGEMENT'S REPORT

The accompanying consolidated financial statements of CryptoLogic Inc. and all of the information in this Annual Report are the responsibility of Management and have been approved by the Board of Directors.

The financial statements have been prepared by management in accordance with generally accepted accounting principles in Canada. The financial statements include some amounts that are based on best estimates and judgement. Management has determined such amounts on a reasonable basis in order to ensure that the financial statements are presented fairly, in all material respects. Financial information used elsewhere in the Annual Report is consistent with that in the financial statements.

CryptoLogic Inc.'s policy is to maintain systems of internal accounting and administrative controls of high quality, consistent with reasonable cost. Such systems are designed to provide reasonable assurance that the financial information is relevant, accurate and reliable and that the Corporation's assets are appropriately accounted for and adequately safeguarded.

The Board of Directors is responsible for ensuring that Management fulfills its responsibilities for financial reporting and is ultimately responsible for approving the financial statements. The Board carries out this responsibility principally through its Audit Committee.

The Audit Committee is appointed by the Board and is comprised of a majority of outside Directors. The committee meets periodically with Management and the external auditors, to discuss internal controls over the financial reporting process, auditing matters and financial reporting issues to satisfy itself that each party is properly discharging its responsibilities. The Audit Committee reviews the Corporation's annual consolidated financial statements, the external auditor's report and other information in the Annual Report. The committee reports its findings to the Board for consideration by the Board when it approves the financial statements for issuance to the shareholders.

On behalf of the shareholders, the financial statements have been audited by Solursh, Feldman & Partners, the external auditors, in accordance with generally accepted auditing standards. Solursh, Feldman & Partners has full and free access to the Audit Committee.



Andrew Rivkin
President and Chief Executive Officer



Mark Rivkin
Executive Vice President
and Chief Operating Officer

CRYPTOLOGIC INC.
CONSOLIDATED FINANCIAL STATEMENTS
YEAR ENDED DECEMBER 31, 1997

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Solursh Feldman
& PARTNERS
The Skoglund Centre
7 Skoglund Avenue East
Suite 3100
North York, Ontario
Canada M2N 1Y7



AUDITORS' REPORT

To the Shareholders of
CryptoLogic Inc.

We have audited the consolidated balance sheet of **CryptoLogic Inc.** as at December 31, 1997 and 1996 and the consolidated statements of earnings (loss) and retained earnings (deficit) and changes in financial position for each of the years then ended. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with 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 December 31, 1997 and 1996 and the results of its operations and the changes in its financial position for each of the years then ended (note 11), in accordance with generally accepted accounting principles.

Solursh Feldman & Partners

CHARTERED ACCOUNTANTS

Toronto, Canada
February 5, 1998


CRYPTOLOGIC INC.
 (INCORPORATED UNDER THE ONTARIO BUSINESS CORPORATIONS ACT)
 CONSOLIDATED BALANCE SHEET
 DECEMBER 31, 1997

	1997	1996
ASSETS		
CURRENT		
Cash and short-term investments	\$ 9,446,045	\$ 742,292
Accounts receivable	538,586	-
Reserves and deposits with credit card processors	3,074,974	-
Sundry receivables and prepaid expenses	125,702	<u>23,227</u>
	13,185,307	765,519
CAPITAL ASSETS (note 2)	362,128	119,500
NOTE RECEIVABLE (note 3)	32,000	-
DUE FROM DIRECTOR	-	20,000
	<u>\$ 13,579,435</u>	<u>\$ 905,019</u>
LIABILITIES		
CURRENT		
Accounts payable and accrued charges	\$ 930,681	\$ 140,260
Accrued payroll and source deductions	19,291	17,713
Income taxes payable	318,555	-
Deposit from licensee	178,638	-
Funds held on deposit	812,350	<u>57,769</u>
	<u>2,259,515</u>	<u>215,742</u>
SHAREHOLDERS' EQUITY		
CAPITAL STOCK (note 4)	3,521,052	1,631,218
RETAINED EARNINGS (DEFICIT)	7,798,868	<u>(941,941)</u>
	<u>11,319,920</u>	<u>689,277</u>
	<u>\$ 13,579,435</u>	<u>\$ 905,019</u>

APPROVED ON BEHALF OF THE BOARD



 Director



 Director

CRYPTOLOGIC INC.
CONSOLIDATED STATEMENT OF EARNINGS AND RETAINED EARNINGS
YEAR ENDED DECEMBER 31, 1997

	1997	(Note 11) 1996
REVENUE		
Fees	\$ 17,655,260	\$ 205,405
Sundry	<u>192,092</u>	<u>8,488</u>
	<u>17,847,352</u>	<u>213,893</u>
EXPENSES		
Software Development and Support Costs	4,134,045	556,520
General and Administrative	769,667	236,368
Financial	(188,305)	2,408
Amortization	<u>51,041</u>	<u>21,003</u>
	<u>4,766,448</u>	<u>816,299</u>
EARNINGS (LOSS) BEFORE THE UNDERNOTED	<u>13,080,904</u>	<u>(602,406)</u>
Write-down of receivables (note 8)	3,463,028	-
Defence of legal action (note 9)	<u>558,512</u>	<u>-</u>
	<u>4,021,540</u>	<u>-</u>
EARNINGS (LOSS) BEFORE PROVISION FOR INCOME TAXES	<u>9,059,364</u>	<u>(602,406)</u>
Provision for income taxes (note 10)	<u>318,555</u>	<u>-</u>
NET EARNINGS (LOSS)	<u>8,740,809</u>	<u>(602,406)</u>
DEFICIT – BEGINNING OF YEAR	<u>(941,941)</u>	<u>(339,535)</u>
RETAINED EARNINGS (DEFICIT) – END OF YEAR	<u>\$ 7,798,868</u>	<u>\$ (941,941)</u>

CRYPTOLOGIC INC.
CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION
YEAR ENDED DECEMBER 31, 1997

	1997	(Note 11) 1996
CASH PROVIDED BY (USED FOR)		
OPERATING ACTIVITIES		
Net earnings (loss)	\$ 8,740,809	\$ (602,406)
Items not affecting cash:		
Amortization	51,041	21,003
Loss on disposal of capital assets	2,848	4,591
	8,794,698	(576,812)
Changes in operating aspects of working capital:		
Accounts receivable	(538,586)	-
Reserves and deposits with credit card processors	(3,074,974)	-
Sundry receivables and prepaid expenses	(102,475)	(4,988)
Accounts payable and accrued charges	790,421	95,149
Accrued payroll and source deductions	1,578	17,713
Income taxes payable	318,555	-
Deposit from licensee	178,638	-
Funds held on deposit	754,581	57,769
	7,122,436	(411,169)
INVESTMENT ACTIVITIES		
Additions to capital assets	(296,517)	(88,776)
FINANCING ACTIVITIES		
Capital stock, conversion of preference shares and warrants issued	1,889,834	908,600
Note receivable	(32,000)	-
Due from director	20,000	(20,000)
	1,877,834	888,600
INCREASE IN CASH POSITION	8,703,753	388,655
CASH POSITION – BEGINNING OF YEAR	742,292	353,637
CASH POSITION – END OF YEAR	\$ 9,446,045	\$ 742,292
CASH AND EQUIVALENTS		
Cash and short-term investments	\$ 9,446,045	\$ 742,292

CRYPTOLOGIC INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 1997

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accounting policies of the company are in accordance with generally accepted accounting principles. Outlined below are those policies considered particularly significant:

a) PRINCIPLES OF CONSOLIDATION

The consolidated financial statements include the accounts of the company and its wholly owned subsidiaries.

b) CAPITAL ASSETS AND AMORTIZATION

Capital assets are stated at cost. Amortization, based on the estimated useful lives of the assets, is provided using the following annual rates and methods:

Computer equipment	30%	Diminishing balance
Computer software	100%	Diminishing balance
Office furniture and equipment	20%	Diminishing balance
Leasehold improvements	3 years	Straight line

c) INCOME TAXES

The company accounts for income taxes using the deferral method of tax allocation, under which income taxes are provided in the year transactions affect net income, regardless of when such transactions are recognized for tax purposes.

d) USE OF ESTIMATES

The preparation of financial statements, in conformity with 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.

e) TRANSLATION OF FOREIGN CURRENCIES

Balances denominated in foreign currencies are translated into Canadian dollars using the exchange rates prevailing at the end of the year for assets and liabilities and the average exchange rates during the year for revenues and expenses. The adjustment arising from the translation of these accounts has been included in the current year's statement of earnings.

2. CAPITAL ASSETS

	1997		(Note 11) 1996	
	Cost	Accumulated Amortization	Cost	Accumulated Amortization
Computer equipment	\$ 364,484	\$ 66,577	\$ 135,281	\$ 20,166
Computer software	500,000	499,999	500,000	499,999
Office furniture and equipment	47,958	3,912	5,222	838
Leasehold improvements	20,936	762	—	—
	<u>\$ 933,378</u>	<u>\$ 571,250</u>	<u>\$ 640,503</u>	<u>\$ 521,003</u>
Net book value		<u>\$ 362,128</u>		<u>\$ 119,500</u>

CRYPTOLOGIC INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 1997

3. NOTE RECEIVABLE

Note receivable consists of a loan issued to an officer to assist him in purchasing 160,000 class "C" share warrants at \$0.20. Each warrant entitles the holder to purchase one common share at a price of \$5.00 per share for a five year period, expiring February 10, 2002.

The loan bears interest at the Toronto-Dominion Bank's published prime lending rate.

Interest and principal are due on February 10, 1999.

\$ 32,000

4. CAPITAL STOCK

Authorized
Unlimited common shares
4,000,000 non-cumulative, redeemable, preference shares.
Redeemable at \$0.10 per share, non-cumulative
dividend of 5% of redemption amount

	1997	(Note 11) 1996
Issued		
7,864,020 common shares (1996 – 5,589,553 shares)	\$ 3,365,079	\$ 1,494,473
1,099,480 preference shares (1996 – 1,123,280 shares)	114,273	116,745
97,000 series "B" warrants (1996 – 200,000 warrants)	9,700	20,000
160,000 series "C" warrants	<u>32,000</u>	<u>–</u>
	<u>\$ 3,521,052</u>	<u>\$ 1,631,218</u>

During the year, 23,800 (1996 – 1,793,553) preference shares were converted into common shares on a one for one basis.

CLASS "A" COMMON SHARE PURCHASE WARRANT

The directors by resolution approved an amendment to the class "A" common share purchase Warrant which entitles the holder to purchase upon payment of \$0.50 per share up to 5.8 million common shares in the capital of the Corporation. This Warrant is exercisable in whole or in part, at any time and from time to time, on or after January 2, 1996 and on or before January 2, 2001. Notwithstanding the foregoing, this Warrant shall not be exercisable until such time as the Corporation shall have achieved cumulative after-tax earnings since January 2, 1996 of in excess of \$5,000,000 whereupon this qualification shall cease to limit the exercise of the Warrant.

SUBSEQUENT EVENT

At a special shareholders' meeting held February 2, 1998, the shareholders of the company ratified the above amendment to the class "A" common share purchase Warrant.

SERIES "A" WARRANT

During the year, 416,000 series "A" warrants were exercised purchasing 208,000 common shares at \$3.00 per share. As at December 31, 1997, no series "A" warrants were outstanding.

CRYPTOLOGIC INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 1997

4. CAPITAL STOCK (cont'd)

SERIES "B" WARRANTS

In 1996, the company issued 200,000 series "B" share purchase warrants entitling the holder to purchase one common share at a price of \$2.50 per share for each warrant for a five year period, expiring August 31, 2001.

During the year, 103,000 series "B" warrants were exercised. As at December 31, 1997, 97,000 warrants remain outstanding.

SERIES "C" WARRANTS

During the year, the company issued 160,000 series "C" share purchase warrants entitling the holder to purchase one common share for each warrant at a price of \$5.00 per share for a five year period, expiring February 10, 2002. (See note 3)

COMPENSATION WARRANTS

The company had issued 1,500,000 compensation warrants to sales agents for their services in obtaining financing for the company. Each compensation warrant entitles the holder to purchase one common share in the company at a price of \$0.50 per share. The warrants expire January 9, 1999. During the year, 1,100,000 warrants were exercised. As at December 31, 1997, 400,000 compensation warrants remained outstanding.

5. STOCK OPTION PLAN

The company had adopted a stock option plan with 900,000 common shares reserved for this plan. The options are granted at the discretion of the board of directors. At January 1, 1997, 870,000 options were outstanding. During the year, 839,667 options were exercised, 785,700 were granted and 14,533 were cancelled. As at December 31, 1997, 801,500 options remain outstanding, as follows:

Number of Shares	Price Per Share	Expiry Date
30,000	\$ 0.50	March 4, 1999
500	23.75	May 3, 1999
2,000	19.00	May 1, 2000
10,000	3.05	January 6, 2001
109,700	7.00	February 11, 2001
31,000	21.00	October 27, 2001
14,700	8.26	May 26, 2002
603,600	8.00	July 8, 2002

6. CONTINGENCIES AND COMMITMENTS

In the preparation of initiating an ongoing relationship with a credit card processor, a wholly owned subsidiary has outstanding, an irrevocable stand by letter of credit in the amount of \$300,000 US. At this time, this letter of credit is not callable, as credit card processing has not begun.

The company has entered into lease agreements expiring at various periods up to October 31, 2000. The future minimum annual rental payments on the operating leases are as follows:

1998	\$ 247,338
1999	257,870
2000	209,053

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7. EARNINGS (LOSS) PER SHARE INFORMATION

	1997	(Note 11) 1996
a) Earnings (loss) per share	\$ 1.27	\$ (0.12)
b) Fully diluted earnings (loss) per share	0.61	(0.11)

8. WRITE-DOWN OF RECEIVABLE

The company's credit card processor has experienced financial difficulties, which left them unable to meet their obligations to the company.

The total outstanding receivable has been written-down as the collectability of this receivable could not be determined at the date of the audit.

9. DEFENCE OF LEGAL ACTION

The company settled a legal action relating to the original class "A" common share purchase warrant. The original warrant was amended, as more fully described in note 4.

10. INCOME TAXES

The income tax provision differs from amounts which would be obtained by applying the Canadian statutory income tax rate to the earnings before income tax. The following explains the major differences between expected taxes and actual taxes:

Earnings before income taxes	\$ 9,059,364	
Income taxes based on a statutory rate of 44.6%	\$ 4,040,476	
Increase (decrease) in income taxes resulting from:		
Lower effective income tax rates of foreign subsidiaries	(3,827,204)	
Utilization of losses carried forward	(94,998)	
Deferred financing costs for income tax purpose relating to defence of legal action	199,277	
Other	1,004	
Actual income taxes	\$ 318,555	

11. COMPARATIVE FINANCIAL INFORMATION

Comparative financial information is for the period from March 7, 1996 to December 31, 1996.

Certain statement figures have been reclassified to conform to the current year's financial statement presentation.