

PhotoChannel Networks Inc.

Consolidated Financial Statements
September 30, 2001, 2000 and 1999
(expressed in Canadian dollars)

Auditors' Report

To the Shareholders and Directors of PhotoChannel Networks Inc.

We have audited the consolidated balance sheets of **PhotoChannel Networks Inc.** as at September 30, 2001 and 2000 and the consolidated statements of loss and deficit, shareholders' equity and cash flows for the years ended September 30, 2001, 2000 and 1999. 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 audits.

We conducted our audits in accordance with Canadian and US 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 September 30, 2001 and 2000 and the results of its operations and its cash flows for the years ended September 30, 2001, 2000 and 1999 in accordance with Canadian generally accepted accounting principles.

"PricewaterhouseCoopers LLP"

Chartered Accountants

Vancouver, B.C., Canada
February 28, 2002

Comments by Auditor for US Readers on Canada-US Reporting Difference

In the United States, reporting standards for auditors require the addition of an explanatory paragraph (following the opinion paragraph) when the financial statements are affected by conditions and events that cast substantial doubt on the company's ability to continue as a going concern, such as those described in Note 1 to the financial statements. Our report to the shareholders dated February 28, 2002 is expressed in accordance with Canadian reporting standards which do not permit a reference to such events and conditions in the auditor's report when these are adequately disclosed in the financial statements.

"PricewaterhouseCoopers LLP"

Chartered Accountants

Vancouver, B.C., Canada
February 28, 2002

PhotoChannel Networks Inc.

Consolidated Balance Sheets

As at September 30, 2001, 2000 and 1999

(expressed in Canadian dollars)

	2001 \$	2000 \$
Assets		
Current assets		
Cash and cash equivalents	5,791	5,229,057
Short-term deposits	10,187	754,173
Cash held in trust	226	-
Accounts receivable	88,004	595,587
Prepaid expenses and deposits	26,767	1,005,096
Inventory	-	40,822
	<u>130,975</u>	<u>7,624,735</u>
Property, plant and equipment	1,357,301	5,388,902
Intangible assets	-	<u>2,702,300</u>
	<u>1,488,276</u>	<u>15,715,937</u>
Liabilities		
Current liabilities		
Accounts payable	4,483,316	1,334,521
Accrued liabilities	701,954	106,750
Advance on private placement	508,873	-
Current portion of obligation under capital leases	453,658	242,035
Demand loan, including \$155,080 due to a related party	467,986	-
	<u>6,615,787</u>	<u>1,683,306</u>
Long-term obligation under capital leases	-	<u>368,499</u>
	<u>6,615,787</u>	<u>2,051,805</u>
Shareholders' Equity		
Capital stock		
Issued and outstanding 41,776,587 (2000 - 29,865,766) common shares without par value	24,168,231	16,315,246
Contributed surplus	5,927,262	59,857
Special warrants	-	9,105,302
Warrants	2,150,000	5,424,500
Deferred compensation	(261,000)	-
Deficit	<u>(37,112,004)</u>	<u>(17,240,773)</u>
	<u>(5,127,511)</u>	<u>13,664,132</u>
	<u>1,488,276</u>	<u>15,715,937</u>

Nature of operations and going concern (note 1)

Contingency (note 23)

Subsequent events (note 25)

Approved by the Board of Directors

"Peter Scarth" Director

"Kyle Hall" Director

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

PhotoChannel Networks Inc.

Consolidated Statements of Shareholders' Equity

For the years ended September 30, 2001, 2000 and 1999

(expressed in Canadian dollars)

	Common stock						Other capital accounts				
	Number of shares	Amount \$	Contributed surplus \$	Convertible notes \$	Special/agents warrants	Amount \$	Warrants	Amount \$	Deferred compensation	(Deficit) retained earnings \$	Total shareholders' equity \$
Balance - September 30, 1998											
Issued for cash	9,849,888	6,972,656	-	200,200	121,250	97,000	1,527,453	332,985	-	(8,103,632)	(500,791)
Shares issued on exercise of special warrants	3,627,344	1,850,020	-	-	-	-	-	-	-	-	1,850,020
Shares issued on exercise of share purchase warrants	121,250	97,000	-	-	(121,250)	(97,000)	-	-	-	-	532,211
Shares issued in settlement of note payable	1,330,527	822,266	-	-	-	-	(1,330,527)	(290,055)	-	-	15,000
Shares issued on conversion of convertible notes	48,387	15,000	-	-	-	-	-	-	-	-	-
Expiry of warrants	422,375	168,950	-	(168,950)	-	-	(196,926)	(42,930)	-	-	-
Loss for the year	-	-	-	-	-	-	-	-	-	(2,196,785)	(2,196,785)
Balance - September 30, 1999	15,399,771	9,925,892	42,930	31,250	-	-	-	-	-	(10,300,417)	(300,345)
Issued for cash	6,945,154	1,910,905	-	-	-	-	3,336,154	3,697,500	-	-	5,608,405
Issuance of warrants	-	-	-	-	-	-	1,000,000	1,700,000	-	-	1,700,000
Issuance of warrants in exchange for services provided	-	-	-	-	-	-	-	450,000	(450,000)	-	-
Vesting of warrants	-	-	-	-	-	-	-	-	27,000	-	27,000
Private placement of 10,000,000 special warrants and 1,000,000 agents warrants	-	-	-	-	11,000,000	9,105,302	-	-	-	-	9,105,302
Issuance of convertible debenture and warrants	-	-	-	2,277,981	-	-	960,000	22,019	-	-	2,300,000
Issuance of shares for cash from exercised options	1,024,433	516,384	-	-	-	-	-	-	-	-	516,384
Conversion option component of convertible debenture	-	-	-	108,160	-	-	-	-	-	-	108,160
Shares issued on conversion of convertible debenture	136,408	128,905	16,927	(31,250)	-	-	-	-	-	-	114,582
Shares issued on conversion of convertible debenture	800,000	508,160	-	(108,160)	-	-	-	-	-	-	400,000
Shares issued on conversion of convertible debenture	4,600,000	2,277,981	-	(2,277,981)	-	-	-	-	-	-	-
Shares issued on exercise of share purchase warrants	960,000	1,047,019	-	-	-	-	(960,000)	(22,019)	-	-	1,025,000
Loss for the year	-	-	-	-	-	-	-	-	-	(6,940,356)	(6,940,356)
Balance - September 30, 2000	29,865,766	16,315,246	59,857	-	11,000,000	9,105,302	4,336,155	5,847,500	(423,000)	(17,240,773)	13,664,132
Shares issued on exercise of warrants	836,154	836,154	926,720	-	-	-	(836,154)	(926,720)	-	-	836,154
Issuance of shares for cash from exercised options	74,667	37,434	-	-	-	-	-	-	-	-	37,434
Vesting of warrants	-	-	44,000	-	-	-	-	-	-	-	-
Shares and warrants issued on conversion of special warrants	11,000,000	6,979,397	-	-	(10,000,000)	(9,028,802)	5,500,000	2,049,405	162,000	-	-
Expiry of warrants	-	-	2,770,780	-	-	-	(2,500,000)	(2,770,780)	-	-	-
Expiry of warrants	-	-	2,049,405	-	-	-	(5,500,000)	(2,049,405)	-	-	-
Expiry of agents warrants	-	-	76,500	-	(1,000,000)	(76,500)	-	-	-	-	-
Loss for the year	-	-	-	-	-	-	-	-	-	(19,871,231)	(19,871,231)
Balance - September 30, 2001	41,776,587	24,168,231	5,927,262	-	-	-	1,000,001	2,150,000	(261,000)	(37,112,004)	(5,127,511)

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

PhotoChannel Networks Inc.

Consolidated Statements of Loss and Deficit

For the years ended September 30, 2001, 2000 and 1999

(expressed in Canadian dollars)

	2001 \$	2000 \$	1999 \$
Revenue	97,112	126,313	160,560
Cost of sales	126,036	10,810	10,583
Gross (loss) profit	(28,924)	115,503	149,977
Expenses			
Amortization	2,927,337	283,167	115,181
Impairment write down	4,307,926	-	-
General and administration	9,264,785	5,313,692	1,346,175
Sales and marketing	2,142,640	681,730	247,078
Research and development	1,411,628	872,031	647,803
Translation gain	(269,924)	-	-
	19,784,392	7,150,620	2,356,237
	(19,813,316)	(7,035,117)	(2,206,260)
Interest expense	110,125	120,676	-
Interest income	52,210	215,437	9,475
Loss for the year	(19,871,231)	(6,940,356)	(2,196,785)
Deficit - Beginning of year	(17,240,773)	(10,300,417)	(8,103,632)
Deficit - End of year	(37,112,004)	(17,240,773)	(10,300,417)
Basic and diluted loss per share attributable to common shareholders	0.60	0.32	0.18
Weighted average number of common shares outstanding	33,187,579	21,873,716	12,112,461
Nature of operations and going concern (note 1)			

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

PhotoChannel Networks Inc.
Consolidated Statements of Cash Flows
For the years ended September 30, 2001, 2000 and 1999

(expressed in Canadian dollars)

	2001 \$	2000 \$	1999 \$
Cash flows from operating activities			
Loss for the year	(19,871,231)	(6,940,356)	(2,196,785)
Items not affecting cash			
Amortization	2,927,337	283,167	115,181
Impairment write down	4,307,926	-	-
Loss on sale of property, plant and equipment	53,144	-	13,713
Issuance of options and warrants for goods and services received	206,000	27,000	-
Interest accretion on convertible debenture	-	108,160	-
Net change in non-cash working capital items	5,270,733	(826,913)	(107,423)
	<u>(7,106,091)</u>	<u>(7,348,942)</u>	<u>(2,175,314)</u>
Cash flows from investing activities			
Purchase of property, plant and equipment	(1,186,256)	(4,710,973)	(54,359)
Short term deposits	743,986	(754,173)	-
Deferred website development costs	-	(1,002,300)	-
Proceeds from sale of property, plant and equipment	631,750	-	18,333
	<u>189,480</u>	<u>(6,467,446)</u>	<u>(36,026)</u>
Cash flows from financing activities			
Cash in trust	(226)	-	165,420
Bank indebtedness	-	-	(105,539)
Repayment on capital lease	(156,876)	-	-
Note payable and convertible notes	-	-	(5,000)
Advance on private placement	508,873	-	-
Issuance of common shares and warrants	-	6,124,789	1,850,020
Issuance of common shares on exercise of warrants and options	873,588	1,025,000	532,211
Issue of demand loan	467,986	-	-
Issuance of convertible debentures	-	2,700,000	-
Repayment of convertible debentures	-	(62,501)	(72,917)
Issuance of special warrants	-	9,105,302	-
	<u>1,693,345</u>	<u>18,892,590</u>	<u>2,364,195</u>
(Decrease) increase in cash and cash equivalents	<u>(5,223,266)</u>	<u>5,076,202</u>	<u>152,855</u>
Cash and cash equivalents - Beginning of year	<u>5,229,057</u>	<u>152,855</u>	<u>-</u>
Cash and cash equivalents - End of year	<u>5,791</u>	<u>5,229,057</u>	<u>152,855</u>
Supplementary information			
Interest paid	-	120,676	-
Non-cash investing and financing activities consist of:			
Obligation under capital leases	-	610,534	-
Shares issued on settlement of note payable	-	-	15,000
Shares issued on exercise of special warrants	6,979,397	-	97,000
Warrants issued on conversion of special warrants	2,049,405	-	-
Expiry of agents warrants	76,500	-	-
Shares issued on conversion of convertible note	-	-	168,950
Warrants issued in exchange for capitalized web site development	-	1,700,000	-
Conversion of convertible debenture to shares	-	2,814,582	-

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

PhotoChannel Networks Inc.

Notes to Consolidated Financial Statements September 30, 2001, 2000 and 1999

(expressed in Canadian dollars)

1 Nature of operations and going concern

PhotoChannel Networks Inc. (the company) was incorporated on December 1, 1995 in British Columbia and commenced active business operations on January 1, 1996. During the year ended September 30, 1999, the company changed its name from InMedia Presentations Inc. to PhotoChannel Networks Inc.

Historically, the company was engaged in the business of developing and marketing packaged multimedia presentation software products. In July 1999, the company launched its website and on October 2, 2000 the company launched version 2.0 of the website including its e-Processing service in the United States, which provided film processing, scanning, storage and printing of digital images.

On March 16, 2001, there was a change of control in management within the company. The previous management left the company and a new management, lead by a director at the time, Peter Scarth, began to restructure and refocus the company. Under the company's restructuring, new management implemented cost reduction measures including reduction of staff numbers, relocation of premises, reductions in travel and marketing expenses and the elimination of an investor relations program. As part of the company's restructuring, the new management determined that the former business model was not viable, and refocused the company to deliver its existing technology as an e-commerce and Internet infrastructure platform. The PhotoChannel Network electronically connects the photo-finishing retailer and its customers throughout North America (principally in the United States) through the Internet and provides hosting, storage and reporting.

These consolidated financial statements have been prepared using Canadian generally accepted accounting principles applicable to a going concern, which contemplates that the company will realize its assets to settle its obligations in the normal course of business. The use of such principles may not be appropriate due to the fact that as at September 30, 2001, there is substantial doubt that the company will be able to continue as a going concern.

At September 30, 2001, the company has an accumulated deficit of \$37,112,004 (2000 - \$17,240,773) and has incurred significant losses in each of its last four fiscal years. During the year ended September 30, 2001 the company used cash of approximately \$7,106,000 to fund operations whilst obtaining approximately \$1,693,000 from financing activities. The company has and will continue to have capital requirements in excess of its currently available resources. The company is dependent upon the proceeds of future financings to further finance the development and implementation of its business objectives. The company's ability to continue its operations is dependent upon the continued support of its shareholders, obtaining additional financing and generating revenues sufficient to cover its operating costs in an industry characterized by rapid technological change. There is no assurance that the company will be successful in achieving any or all of these objectives over the coming year and, accordingly, there exists substantial doubt that the company will be able to continue as a going concern.

PhotoChannel Networks Inc.

Notes to Consolidated Financial Statements

September 30, 2001, 2000 and 1999

(expressed in Canadian dollars)

Management is implementing a plan to address these issues and to allow the company to continue as a going concern through the end of fiscal year 2002 and beyond. This plan includes obtaining debt or equity financing in amounts sufficient to fund current expenditures and the development of the PhotoChannel Network and subsequent realization of the revenue produced by this network. However, there is only a limited operating history with the existing business model, with no substantial revenues to date, and there is no assurance that the necessary financing can be obtained or on what terms it may be obtained, however, management are confident that the necessary funding will be obtained (note 25). The accompanying financial statements do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amount and classification of liabilities that may result from the outcome of this uncertainty. Such adjustments could be material.

2 Significant accounting policies

Basis of consolidation

These consolidated financial statements include the accounts of the company and each of its subsidiaries, PhotoChannel, Inc., IPE (inactive), PhotoChannel Capital Inc., PhotoChannel Management Inc. and PhotoChannel.com LP. All intercompany balances and transactions are eliminated upon consolidation.

Research and development

Research costs are expensed in the period incurred. Development costs are also expensed unless they meet generally accepted criteria for deferral. The company has not deferred any development costs to date.

Property, plant and equipment

Property, plant and equipment are recorded at cost less accumulated amortization. Amortization of property, plant and equipment and assets capitalized under capital leases is charged over the estimated useful lives of the assets and at the following annual rates:

Computer equipment	30% straight line
Furniture and office equipment	20% straight line
Software	33% - 100% straight line
Leasehold improvements	life of the lease
Photofinishing equipment	20% straight line

Tangibles assets are tested for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. Recoverability is measured by comparison of the carrying amount of any asset to future net undiscounted cash flows expected to be generated by the asset. Any excess of the carrying value over the net recoverable amount is charged to impairment expense.

PhotoChannel Networks Inc.

Notes to Consolidated Financial Statements

September 30, 2001, 2000 and 1999

(expressed in Canadian dollars)

Intangible assets

The company capitalizes the costs incurred for website application and infrastructure development. Amortization is charged over three years on a straight-line basis and commences upon the completion and launch of the website. Costs incurred in planning the development of the website, and operating costs for the website, and training and maintenance are expensed as incurred.

Inventory

Inventory includes raw materials for photo processing and packaged software products for sale and is stated at the lower of average cost and net realizable value.

Revenue recognition

Revenue is recognized when the following criteria have been met: persuasive evidence of an arrangement exists; delivery of services or product has occurred; the price is fixed or determinable customer acceptance has been received or implied and collectibility is reasonably assured.

During the fiscal year ended September 30, 2001 the company earned revenue from the provision of e-processing and network services. These revenues are recognised at the time the digital image processing services are provided to the end customer.

In years prior to the fiscal year ended September 30 2001, the company sold and licensed its packaged software products directly to the end user. In years prior to the fiscal year ended September 30, 2000, the company also sold packaged software through distributors. For these sales, the company considered the risks of return from distributors to be high, accordingly revenue was recognized only after the collection of proceeds for products sold to end users by these distributors.

Share issue costs

Direct costs associated with an issue of capital stock or special warrants are deducted from the related proceeds at the time of the issue.

Stock-based compensation plan

The company has a stock based compensation plan as described in note 14 (a)(iv). No compensation expense is recognized when stock or stock options are issued to employees or directors. Where stock or stock options are issued to non-employees in return for goods or services, the fair value of those options issued are recognised as an expense in the period in which the goods or services are received. Any consideration paid or received on exercise of stock options or purchase of stock is credited to capital stock.

PhotoChannel Networks Inc.

Notes to Consolidated Financial Statements

September 30, 2001, 2000 and 1999

(expressed in Canadian dollars)

Financial instruments

Financial instruments are classified in accordance with the substance of the contractual arrangement. Financial liabilities, which are defined as any contractual obligation to deliver cash or another financial asset to another party, are classified as liabilities. Where a financial instrument contains both a debt and equity component, the instruments are presented in their component parts according to the pro-rated value of the fair values of the components at the time they were originally issued.

Loss per share

Loss per share figures are calculated using the weighted average number of shares outstanding during the year. Diluted loss per share information is not presented where the effect would be anti-dilutive.

Foreign currency translation

Monetary assets and liabilities denominated in foreign currencies are translated into Canadian dollars at the exchange rate prevailing at the balance sheet date. Revenue and expenses denominated in foreign currencies are translated at the exchange rate prevailing at the transaction date. The company translates the financial statements of its subsidiaries into Canadian dollars. Monetary assets and liabilities are translated at the exchange rate prevailing at the balance sheet date. Non-monetary assets are translated at their historic rate. Revenues and expenses are translated at the exchange rate prevailing at the transaction date. Exchange differences are included in income as they arise.

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 amount of assets and liabilities and other reported amounts in the consolidated financial statements and the related notes. Significant estimates and assumptions are necessary in the determination of the recoverable amounts for property plant and equipment and intangible assets and in the determination of the value ascribed to the components of stock based transactions. Actual results may differ from those estimates.

Cash and cash equivalents

Cash and cash equivalents consist of cash on deposit and highly liquid short term interest bearing securities with maturities at the date of purchase of three months or less.

Income taxes

The company uses the liability method of accounting for income taxes. Under the 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 balances. Future tax assets and liabilities are measured using enacted or substantially enacted tax rates expected to apply to the taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on future tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the date of enactment or substantive enactment.

PhotoChannel Networks Inc.
Notes to Consolidated Financial Statements
September 30, 2001, 2000 and 1999

(expressed in Canadian dollars)

Advertising costs

Advertising costs incurred for prints and other media advertisements are recorded as prepaid expenses and expensed the first time the advertising takes place.

Start-up activities

Costs related to the start-up of operations for e-processing are expensed as incurred.

3 Short-term deposits

Short term deposits consists of term deposits with Canadian Chartered Banks and have maturities at the date of initial deposit of one year. These term deposits can be redeemed for their face value plus accrued interest, and therefore, the carrying value approximates their fair value.

4 Accounts receivable

	2001	2000
	\$	\$
GST receivable	70,058	367,977
Leasehold cost reimbursement	-	135,930
Interest	-	33,812
Other	17,946	57,868
	<hr/>	<hr/>
	88,004	595,587
	<hr/>	<hr/>

5 Prepaid expenses and deposits

	2001	2000
	\$	\$
Prepaid advertising	-	485,880
Prepaid investor relations	-	391,222
Prepaid rent, insurance and miscellaneous	26,767	127,994
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	26,767	1,005,096
	<hr/>	<hr/>

PhotoChannel Networks Inc.
Notes to Consolidated Financial Statements
September 30, 2001, 2000 and 1999

(expressed in Canadian dollars)

6 Inventory

	2001	2000
	\$	\$
Packaged software	-	11,352
Photofinishing supplies	-	29,470
	<hr/>	<hr/>
	-	40,822
	<hr/>	<hr/>

7 Property, plant and equipment

	2001			
	Cost	Accumulated	Impairment	Net
	\$	amortization	write-down	\$
	\$	\$	\$	\$
Computer equipment	3,885,866	1,586,838	997,151	1,301,877
Furniture and office equipment	665,402	187,738	423,296	54,368
Software	491,396	491,396	-	-
Leasehold improvements	1,321,758	234,831	1,085,871	1,056
	<hr/>	<hr/>	<hr/>	<hr/>
	6,364,422	2,500,803	2,506,318	1,357,301
	<hr/>	<hr/>	<hr/>	<hr/>

The deterioration of the company's financial position and lower than anticipated level of revenues during the year ended September 30, 2001 indicated the carrying value of certain assets within property, plant and equipment may not be recoverable from future cash flows attributable to those assets. As a result the carrying amount of those assets was compared to the recoverable amount and an impairment provision booked for the amount by which the carrying amount exceeded the recoverable amount.

PhotoChannel Networks Inc.
Notes to Consolidated Financial Statements
September 30, 2001, 2000 and 1999

(expressed in Canadian dollars)

	2000		
	Cost	Accumulated	Net
	\$	amortization	\$
		\$	\$
Computer equipment	3,714,613	430,111	3,284,502
Photofinishing equipment ⁽¹⁾	637,345	-	637,345
Furniture and office equipment	409,982	79,082	330,900
Software	346,123	202,314	143,809
Leasehold improvements	1,026,557	34,211	992,346
	<u>6,134,620</u>	<u>745,718</u>	<u>5,388,902</u>

(1) Installation of the photofinishing equipment was completed and the equipment was ready for use in October 2000, accordingly amortization commenced at that time. The company disposed of this equipment during the year ended September 30, 2001.

Included in the above are assets under capital leases relating to computer equipment, with a cost \$789,299 (2000 - \$896,347) and a net value of \$533,940 (2000 - \$885,143).

8 Intangible assets

	2001			
	Cost	Accumulated	Impairment	Net
	\$	amortization	write-down	\$
		\$	\$	\$
Website development costs	2,702,300	900,767	1,801,533	-

The deterioration of the company's financial position and lower than anticipated level of revenues during the year ended September 30, 2001 indicated the carrying value of intangible may not be recoverable from future cash flows attributable to the intangible asset. As a result the carrying amount of those assets was compared to the recoverable amount and an impairment provision booked for the amount by which the carrying amount exceeded the recoverable amount.

PhotoChannel Networks Inc.
Notes to Consolidated Financial Statements
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(expressed in Canadian dollars)

Amortization commenced with the completion and launch of the version 2.0 of the website in October 2000.

	2000		
	Cost	Accumulated	Net
	\$	amortization	\$
		\$	\$
Website development costs	2,702,300	-	2,702,300

9 Accounts payable

	2001	2000
	\$	\$
Trade payable	3,502,499	1,303,572
Wages and salaries	240,231	-
Withholding taxes payable	740,586	30,949
	<u>4,483,316</u>	<u>1,334,521</u>

10 Accrued liabilities

	2001	2000
	\$	\$
Legal claims	631,342	58,000
Vacation pay	70,612	48,750
	<u>701,954</u>	<u>106,750</u>

11 Demand loan

The demand loan bears interest at 12% per annum and is secured by a general security agreement over the assets of the company and its subsidiaries (note 19).

PhotoChannel Networks Inc.

Notes to Consolidated Financial Statements

September 30, 2001, 2000 and 1999

(expressed in Canadian dollars)

12 Convertible debentures

- a) The company issued a convertible debenture on March 1, 1998. The debenture had a five-year term, and a maturity date of March 1, 2003. Conversion was at the option of the holder at any time to maturity. The convertible debenture was converted into common shares of the company at the option of the holder on March 22, 2000. At the time of conversion a balance of \$114,582 was outstanding on the convertible debenture. As a result of the conversion rate of \$0.84 a share specified in the agreement, 136,408 common shares of the company were issued in full satisfaction of the debt. Interest was payable monthly at the Bank of Nova Scotia prime rate plus 4% or a minimum of 12% per annum. Collateral pledged consisted of a subordinated floating charge on all assets of the company.

The company began payment on the principal amount of the convertible debenture on March 1, 1999. An amount of \$10,417 was payable monthly. However, as the company was in breach of certain covenants relating to the convertible debenture, allowing the holder to make immediate demand on the principal amount outstanding, the company classified the entire principal amount as a current liability.

The convertible debenture was presented in its component parts. These components were measured at their respective fair values at the time they were originally issued. Capital stock was increased by \$31,250 in 1998 to reflect the equity component of the conversion option. A similar amount was recognized as the discount on the issue of the liability component and initially deducted from the face amount of the convertible debenture. Given that the convertible debenture was classified as a current liability, the discount was fully amortized in 1998, and the full face amount of the convertible debenture was shown as due for consolidated financial statement purposes.

- b) The company issued a convertible subordinated debenture on December 31, 1999 for a principal amount of \$400,000. The debenture matured on April 30, 2000, it incurred interest at a rate of 10% per annum up to April 30, 2000 and was convertible into common shares at a rate of \$0.50 per share. Upon maturity, the debenture was converted into common shares of the company at a rate of \$0.50 per share at the option of the holder.

The convertible subordinated debenture was originally recorded in its component parts. These component parts were measured at their respective fair values at the time they were issued. Capital stock was increased by \$108,160 during the year ended September 30, 2000 to reflect the equity component of the conversion option. A similar amount was recognized as the discount on the issue of the liability component and initially deducted from the face amount of the convertible subordinated debenture. The discount was amortized over the term of the debenture and is included in interest expense.

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- c) On January 12, 2000, the company issued a subordinate convertible debenture redeemable at the option of the holder for \$2,300,000. The amounts were advanced at specified dates with the last instalment being on April 14, 2000. The debenture was non-interest bearing and matured on April 30, 2000. The debenture was convertible at either parties' discretion into common shares of the company at a rate of \$0.50 per common share. Pursuant of the agreement, the company agreed to issue the debenture holder an aggregate of 960,000 common share purchase warrants to be issued in accordance with receipt of funds at exercise prices between \$0.75 and \$1.25. The warrants were exercised on June 30, 2000 to acquire common shares of the company at the option of the holder at that date.

The subordinate convertible redeemable debenture was originally recorded in equity because of the company's right to convert the debenture into common shares of the company.

13 Obligation under capital lease

The company has leased computer and office equipment under agreements bearing interest at rates of 18.6%.

The following is a schedule of future minimum lease payments together with the balance of the obligation under capital leases:

	2001	2000
	\$	\$
2001	-	328,854
2002	538,038	413,472
	<hr/>	<hr/>
	538,038	742,326
Less: Amount representing interest	84,380	131,792
	<hr/>	<hr/>
	453,658	610,534
Less: Current portion	453,658	242,035
	<hr/>	<hr/>
	-	368,499
	<hr/>	<hr/>

In the year ended September 30, 2001 interest of \$79,613 (2000 - \$nil, 1999 - \$nil), relating to these capital leases, has been expensed.

PhotoChannel Networks Inc.

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14 Capital stock, special warrants and warrants

a) Capital stock

Authorized

500,000,000 (2000 - 500,000,000; 1999 - 100,000,000) common shares without par value
10,000,000 (2000 - nil; 1999 - nil) preferred shares without par value

Issued

41,776,587 (2000 - 29,865,766; 1999 - 15,399,771) common shares without par value

The shareholders of the company approved an increase in the authorized capital of the company from 100,000,000 to 500,000,000 common shares at an extraordinary general meeting held on June 19, 2000.

- i) Pursuant to private offerings and the non brokered portion of a private placement (note 14(b)) during the year ended September 30, 2000, the company issued 6,945,154 common shares for net proceeds of \$5,608,405. As part of these offerings 3,336,154 transferable common share purchase warrants were issued that entitle the holder to convert each warrant into one common share at prices between \$1.00 and \$1.30 per share. During the year ended September 30, 2001, 836,154 of these share purchase warrants were exercised for 836,154 common shares and the remaining 2,500,000 share purchase warrants expired unexercised on August 9, 2001.
- ii) Pursuant to private offerings during the year ended September 30, 1999, the company issued 3,627,344 common shares for gross proceeds of \$1,943,939 less offering expenses of \$93,919.
- iii) Pursuant to a private offering in the year ended September 30, 1998, the company issued 3,054,906 units for gross proceeds of \$947,021 less offering expenses of \$41,474. Each unit consisted of one common share and one-half of a transferable share purchase warrant. The holders thereof were entitled to exercise their warrants into an aggregate of 1,527,453 common shares for an additional consideration of \$0.40 per share. These warrants expired one year after issuance. During the year ended September 30, 1999, 1,330,527 warrants were exercised for 1,330,527 common shares. The remaining unexercised warrants expired.
- iv) During 1997, the company initiated a stock option plan. As at September 30, 2001, the company has reserved 10,444,146 common shares (2000 - 9,932,000; 1999 - 3,138,000) under the plan. The options, which expire five years after the date granted, are subject to various vesting requirements. The majority of options vest one third on date of grant and one third on each of the first and second anniversaries of the date of grant, while some are fully vested upon grant.

During the year ended September 30, 1998, the exercise price of certain options was reduced from a range of \$2.50 to \$4.50 per option to \$1.13 per option. During the year ended September 30, 1999, the exercise price was further reduced to \$0.50 per option. During the year ended September 30, 2001 certain options with exercise price of \$1.91 were cancelled and replaced by options with exercise price of US\$1.00.

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During the year ended September 30, 2001 the company issued options to non-employees for services provided to the company. The fair value of the options issued was calculated on completion of the services provided using the Black-Scholes option-pricing model using the following weighted average assumptions: dividend yield of nil; expected volatility of 100%; risk free interest rate of 4.00%; and expected life of 5 years. The resulting value of \$44,000 was charged as an expense in the period that the services were provided.

Options

A summary of the status of the company's stock option plan as of September 30, 2001, 2000 and 1999 and changes in the periods ending on those dates is presented below:

	<u>2001</u>		<u>2000</u>		<u>1999</u>	
	<u>Shares</u>	<u>Weighted average exercise price \$</u>	<u>Shares</u>	<u>Weighted average exercise price \$</u>	<u>Shares</u>	<u>Weighted average exercise price \$</u>
Outstanding - Beginning of year	9,843,520	1.46	3,138,000	0.56	270,000	1.19
Granted	9,303,058	0.70	10,519,686	1.63	2,868,000	0.51
Exercised	(74,667)	0.50	(1,024,433)	0.50	-	-
Cancelled	<u>(9,551,722)</u>	1.39	<u>(2,789,733)</u>	0.59	<u>-</u>	-
	<u>9,520,189</u>	0.66	<u>9,843,520</u>	1.46	<u>3,138,000</u>	0.56
Options exercisable - End of year	<u>5,050,397</u>	0.83	<u>4,418,106</u>	1.26	<u>1,152,667</u>	0.64

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The following table summarizes information about stock options outstanding at September 30, 2001:

<u>Options outstanding</u>			<u>Options exercisable</u>		
Number outstanding at September 30, 2001	Weighted average exercise prices \$	Weighted average remaining contractual life (years)	Number exercisable at September 30, 2001	Weighted average exercise prices \$	Weighted average remaining contractual life (years)
5,400,000	0.15	4.8	1,800,000	0.15	4.8
195,333	0.50	2.3	195,333	0.50	2.2
125,000	0.72	2.6	125,000	0.72	2.6
1,050,000	1.00	4.2	891,667	1.00	4.0
175,000	1.13	1.4	175,000	1.13	1.4
15,000	1.47	0.4	15,000	1.47	0.4
2,359,856	US1.00	3.9	1,748,397	US1.00	3.9
100,000	1.57	4.0	33,333	1.57	4.0
100,000	1.91	3.7	66,667	1.91	3.7
<u>9,520,189</u>	<u>0.66</u>		<u>5,050,397</u>	<u>0.83</u>	

b) Special warrants

On May 1, 2000, the company entered into a private placement for gross proceeds of \$15,000,000 on a partly brokered partly non-brokered basis.

The brokered portion of the placement consisted of 10,000,000 special warrants (the special warrants) at a price of \$1.00 per special warrant. Each special warrant was exercisable to acquire, for no additional consideration, one common share (a share) in the capital of the company and one half of one common share purchase warrant (a purchase warrant). Each whole purchase warrant entitled the holder to acquire a further common share at a price of \$1.30 per share for a period of one year from the earlier of (i) the date of the issuance receipts (the Receipts) for a final prospectus (the Prospectus) qualifying the distribution of the shares and purchase warrants on exercise of the special warrants, and (ii) August 9, 2000. The company did not obtain a receipt for the final Prospectus before August 9, 2000, therefore each special warrant will entitle the holder thereof to receive 1.1 shares and 0.55 purchase warrants. During the year ended September 30, 2001 the Special warrants were converted to 11,000,000 common shares and 5,500,000 purchase warrants for no additional consideration. The proceeds of the issuance of the special warrants was allocated to the common shares and purchase warrants according to the pro-rated fair value of the common shares and the purchase warrants at the date of issuance of the special warrants. The purchase warrants expired unexercised on August 9, 2001.

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The agent for the company in soliciting offers to purchase the special warrants was paid a cash commission equal to 7.5% of the gross proceeds raised from the sale of the special warrants and was provided agent compensation warrants. The agent compensation warrants were exercisable to acquire, for no additional consideration, compensation options which entitle the agent to purchase up to 1,000,000 Units at a price of \$1.00 per Unit, for a period of one year from the earlier of (i) the date of the issuance of the Receipts and (ii) August 9, 2000. Each Unit consisted of one common share and one half of a purchase warrant. The agent was also entitled to a 10% increase in the number of agent compensation warrants, as the Receipt was not obtained on or before August 9, 2000.

The non-brokered portion consisted of 5,000,000 units at a price of \$1.00 per unit for gross proceeds of \$5,000,000. Each unit consisted of one common share and one half of a purchase warrant. The purchase warrants expired unexercised on August 9, 2001.

c) Warrants

During the year ended September 30, 2000, the company retained Interactive Capital Partners LLC (Interactive) to provide financial advisory services to their subsidiary in the United States. The agreement expires on June 30, 2002 and may be terminated by either party on 30 days notice. As consideration under the agreement, and subject to regulatory approval, the company has agreed to issue Interactive 1,000,000 share purchase warrants. Vested warrants are exercisable on or before the earlier of (i) the termination of the agreement and (ii) August 1, 2002, at a price of \$1.90 per share. The warrants will vest as to 30,000 per month commencing August 1, 2000 with all outstanding warrants vesting in the event that the company completes a merger or acquisition introduced to the company by Interactive. The warrants expire on August 1, 2002.

During the year ended September 30, 2001, 360,000 warrants vested (2000 - 60,000 warrants) and were assigned a value of \$162,000 (2000 - \$27,000), which has been included as an expense and recorded in equity. The value of the warrants were determined using the Black-Scholes option-pricing model using the following weighted average assumptions: dividend yield of nil; expected volatility of 131%; risk free interest rate of 5.33%; and expected life of 2 years. During the year ended September 30, 2001, the company gave notice to Interactive and, subsequent to the year-end, terminated the agreement and cancelled the outstanding warrants.

On May 11, 2000, the company entered into a five year software licence and service agreement with MCL Software Services Inc. (MCL), to licence software that will enable the company to print images uploaded to its website. The company paid MCL a US\$15,000 license fee and agreed to provide MCL with a royalty equal to a percentage of the net margin earned by the company from using the MCL software to print digital images. MCL has agreed to provide technical maintenance services related to the MCL software during the term of the MCL agreement. In addition to the license fee, the company also granted to MCL a warrant, exercisable for a period of five years, to purchase up to 1,000,000 common shares of the company at a price of US\$1.75 per share. The company has the option, in certain circumstances, to purchase a perpetual, irrevocable, non-exclusive, non-assignable licence for the MCL software in return for a one-time payment.

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The MCL warrant was assigned a value of \$1,700,000, which was included as a component of the website development costs and recorded in equity. The value of the warrant was determined using the Black-Scholes option pricing model using the following assumptions: risk free interest rate of 6.17%, an expected volatility of 146%, expected dividend yield of nil and expected life of 5 years.

15 PhotoChannel LP

PhotoChannel Capital Inc. was incorporated on January 25, 2000 to undertake the sale and distribution of units of PhotoChannel.com Limited Partnership (the PhotoChannel LP) and is the sole shareholder of PhotoChannel Management Inc. PhotoChannel Management Inc. was incorporated on January 25, 2000 and is the general partner of the PhotoChannel LP. The PhotoChannel LP was established pursuant to an amended and restated limited partnership agreement (dated April 12, 2000 entered into among PhotoChannel Management Inc., as general partner, and the purchasers of PhotoChannel LP units). The PhotoChannel LP incurred start-up costs of \$1,457,743. No limited partnership units were issued and therefore all costs have been allocated to the company and are classified in general and administration costs. The company has suspended operations in both PhotoChannel Capital Inc. and PhotoChannel Management Inc and the PhotoChannel LP is inactive. Neither subsidiary company has any ongoing business requirements.

16 Net change in non-cash working capital items

	2001 \$	2000 \$	1999 \$
Accounts receivable	507,583	(595,587)	-
Inventory	40,822	(19,995)	9,439
Prepaid and deposits	978,329	(992,620)	100,720
Accounts payable	3,148,795	730,138	(217,582)
Accrued liabilities	595,204	51,151	-
	5,270,733	(826,913)	(107,423)

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17 Expense detail

	2001 \$	2000 \$	1999 \$
General and administration			
Salaries and consulting	4,992,072	2,389,495	727,698
Accounting and legal	928,702	506,255	146,044
Investor relations	278,257	360,350	-
Office and miscellaneous	2,010,123	712,181	385,531
PhotoChannel LP losses	347,326	1,110,417	-
Rent	721,543	234,994	86,902
Loss on disposal of property, plant and equipment	53,144	-	-
Settlement of debt	(66,382)	-	-
	<u>9,264,785</u>	<u>5,313,692</u>	<u>1,346,175</u>
Sales and marketing			
Salaries and consulting	368,911	132,332	133,765
Printing, advertising and promotion	1,729,012	510,519	2,095
Miscellaneous	44,717	38,879	111,218
	<u>2,142,640</u>	<u>681,730</u>	<u>247,078</u>
Research and development			
Salaries and consulting	1,176,626	325,684	240,245
Website planning	205,986	519,518	398,733
Miscellaneous	29,016	26,829	8,825
	<u>1,411,628</u>	<u>872,031</u>	<u>647,803</u>

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18 Income taxes

The company is subject to US federal and state income taxes and Canadian federal and provincial taxes.

The company has non-capital losses for Canadian income tax purposes of approximately \$16,921,055, which are available for carry forward to reduce future years' taxable income. These income tax losses expire as follows:

	\$
Year ending September 30	
2003	594,800
2004	3,520,400
2005	2,720,600
2006	2,064,600
2007	5,390,900
2008	<u>2,629,755</u>
	<u>16,921,055</u>

In addition, the company has non-capital losses for US income tax purposes of approximately \$11,585,213 which are available for carryforward to reduce future years' taxable income of the US company. These losses expire as follows:

	\$
Year ending September 30	
2017	82,000
2018	173,000
2020	1,324,000
2021	<u>10,006,213</u>
	<u>11,585,213</u>

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Net future income tax assets consist of the following:

	2001	2000	1999
	\$	\$	\$
Net operating loss carryforwards	9,807,144	6,968,000	4,092,000
Property, plant and equipment	2,788,231	329,000	207,000
Share issue costs	92,711	149,000	-
	<hr/>	<hr/>	<hr/>
	12,688,086	7,446,000	4,299,000
Valuation allowance	(12,688,086)	(7,446,000)	(4,299,000)
	<hr/>	<hr/>	<hr/>
Net future income tax assets	-	-	-

Management believes there is sufficient uncertainty regarding the realization of future income tax assets such that a full valuation allowance has been provided.

The income tax recovery for the period ended September 30, 2001 differs from the amount obtained by applying the applicable statutory income tax rates to loss before income taxes as follows:

	2001	2000	1999
	\$	\$	\$
Combined statutory income tax rate	45%	45%	45%
	<hr/>	<hr/>	<hr/>
Income tax recovery based on combined statutory rate	8,942,054	3,123,000	988,000
Effect of lower effective tax rate on losses of foreign subsidiaries	-	(150,000)	-
Effect of change in expected tax rates	(3,635,168)		
Deductible portion of share issuance costs	149,000	187,000	-
Non-deductible expenses and other differences	(213,800)	(13,000)	(10,000)
Change in valuation allowance	(5,242,086)	(3,147,000)	(978,000)
	<hr/>	<hr/>	<hr/>
	-	-	-

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19 Related party transaction

During the year, the company paid consulting fees of approximately US\$202,500 to two former directors and accrued \$111,042, in consulting fees to a company owned by a current director and officer, which remain unpaid at February 28, 2002. This is compared to \$690,000 in 2000 (1999 - \$400,000) to three directors and an officer of the company.

As at September 30, 2001, a director and officer was owed \$155,080, which he had loaned to the company through a credit facility. This amount was subsequently converted into 1,550,795 special warrants as part of the non-brokered private placement, which closed on October 17, 2001.

20 Segmented information

In the year ended September 30, 2001 the company generated all its revenues from its e-processing operations and all losses are attributable to this segment. In the year ended September 30, 2000, the company has derived all of its business and revenue from the development and licensing of its packaged software products in North America. The company's sales for each of the past three years were substantially in the US and no individual customer represented in excess of 10% of sales. Property, plant and equipment and intangible assets are located as follows:

	2001 \$	2000 \$
Canada	1,357,301	3,178,012
US	-	4,913,190
	<hr/> 1,357,301	<hr/> 8,091,202

21 Financial instruments

a) Fair values

The fair values of cash and cash equivalents, short-term deposits, accounts receivable, accounts payable, accrued liabilities, lease obligations and demand loan approximate their carrying amounts due to the near-term maturity of these instruments. The fair value of the debenture component of the convertible debentures and convertible notes is not readily determinable.

b) Credit risk

The company does not have a significant exposure to any individual customer or counter party. The company does not sell on credit or grant credit terms. In prior years, the company did grant credit to certain distributors. In these cases, the company reviewed a new customer's credit history before extending credit and conducted regular reviews of its existing customers' credit performance.

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c) Foreign exchange risk

The company is subject to foreign exchange risk for sales and purchases denominated in foreign currencies. Foreign currency risk arises from the fluctuation of foreign exchange rates and the degree of volatility of these rates relative to the Canadian dollar. The company does not actively manage this risk.

22 Commitments

The company has entered into agreements to lease premises and equipment for periods to 2005. The annual rent for premises includes minimum rent plus realty taxes and operating expenses. Minimum payments for each of the next five years is as follows:

	\$
2002	408,545
2003	381,446
2004	387,957
2005	271,884
2006	-
	<hr/>
	1,449,832

23 Contingency

Other than as set out below, as of February 28, 2002, there were no legal proceedings material to the company to which the company or its subsidiaries are a party or to which their property is subject, nor to the best of the knowledge of management, are any such legal proceedings contemplated.

- a) On February 24, 1999, Thomas Jackson, a former President and Chief Executive Officer of the company, commenced proceedings against the company in the Supreme Court of British Columbia. Mr. Jackson has claimed damages for unpaid services not exceeding \$150,000. Management is of the view that the claim is without merit and is vigorously defending these proceedings. There have been no further proceedings in this matter since the company filed its statement of defence.
- b) On January 13, 2000, Arthur Tesser, the former Chief Operating Officer of PhotoChannel, Inc., commenced arbitration proceedings against PhotoChannel, Inc. for US\$317,000. He is claiming being owed a severance compensation under an employment contract dated July 26, 2000. Mr. Tesser's employment with PhotoChannel, Inc. was terminated in November 2000. Mr. Tesser is also seeking payment from the company for a purported guarantee of the terms of the employment contract by the company.

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The matter is currently before the Arbitrator, but has been placed in abeyance pending guidance from the bankruptcy court. The company, PhotoChannel, Inc. and Mr. Tesser previously negotiated settlement terms, whereby the PhotoChannel, Inc. commenced payments there under and there was US\$106,000 remaining when PhotoChannel, Inc. filed for bankruptcy.

The company is of the view that if the claimant can extricate the claim from the bankruptcy court and the Arbitrator considers the company a participant, the Arbitrator could either enforce the previous settlement agreement or put the onus on the claimant to prove the inter-company guarantee. Management is of the view that the maximum exposure to the company is US\$106,000 (the previously negotiated amount), if the arbitrator subsequently rules in favor of all of Mr. Tesser's claims and rules under the purported guarantee of the company.

- c) On July 4, 2001 Groome Capital.com Inc. of 1, Place Ville-Marie, Suite 2707, Montreal, Quebec commenced an action against the company in the Quebec Superior Court, claiming \$33,613 for legal costs incurred in connection with a proposed financing of the company in January of 2001 which did not completed. The plaintiff has previously been granted a default judgement for this amount. The company and plaintiff and the mise en cause have agreed to an out of court settlement of \$15,000 to be paid by the company by March 31, 2002. This amount has been accrued.
- d) On July 11, 2001 Thomas Public Relations Inc. of 775 Park Avenue, Huntingdon, New York, commenced an action in the Supreme Court of British Columbia, claiming \$46,748.55 plus interest at the rate of 18% per annum, for the provision of public relations services. The company is disputing the claim and filed a statement of defence on August 2, 2001.
- e) On March 3, 1999, the company received a letter from DATT Japan indicating that they had proceeded with legal action in the Japanese courts for an order for payment. On September 10, 2001, a judgment was received from a Japanese court against PhotoChannel for approximately \$99,000. The company intends to defend itself against the enforcement of this judgment.
- f) On October 29, 2001, Mr. Geoffrey Briant, the former Chairman and Chief Executive Officer of the company commenced an action in the Supreme Court of British Columbia, claiming \$113,713 for reimbursement of expenses allegedly incurred by Mr. Briant while he was an officer of the company. On November 21, 2001 the company filed a statement of defence disputing this claim and a counterclaim against Mr. Briant and 328707 B.C. Ltd. The counterclaim against Mr. Briant was for breach of fiduciary duty, unauthorized payments in the amount of \$205,000 and reimbursement of personal expenditures in the amount of \$15,721. The counterclaim against 328707 B.C. Ltd. was for unauthorized payments in the amount of \$20,000. On December 4, 2001, Mr. Briant filed a defence and counterclaimed against two of the company's directors, by virtue of their positions, that they each also breached their fiduciary duties to the company.
- g) On October 31, 2001, Mr. Melvin Reeves, the former Executive Vice President, Chief Strategy Officer and General Counsel of the company commenced an action in the Provincial Court of British Columbia (Small Claims Court), claiming \$8,323 for reimbursement of expenses allegedly incurred by Mr. Reeves while he was an officer of the company. The company is disputing this claim.

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- h) On November 5, 2001, Donald Sutherland of P.O. Box 345, Staten Island, New York, New York, commenced an action in the Supreme Court of British Columbia, claiming \$132,771 plus interest, for the provision of text and photographs and services. The company is disputing the claim.
- i) On November 6, 2001 Compugen Logistics Limited commenced an action in the Supreme Court of British Columbia, claiming \$31,665 for computer equipment and related products allegedly supplied to the company between May 2000 and December 2000. The company has not disputed this claim and the amount is included within accrued liabilities.
- j) On December 21, 2001 Mr. Geoffrey Briant, the former Chairman and Chief Executive Officer of the company commenced an action in the Supreme Court of British Columbia, claiming US\$1,000,000 under a guarantee from the company for wrongful dismissal by PhotoChannel International Limited. The company is disputing the claim.
- k) On December 31, 2001 Northern California Collection Service Inc. of Sacramento, California, commenced an action in the Superior Court of California, claiming US\$118,204 plus interest of US\$21,663 to December 31, 2001 under a contract between the company and Interwoven, Inc. for the provision of computer software. On February 28, 2002, the claimant and the company came to an out of court settlement of US\$17,500, if paid by the company by March 29, 2002.

The company has recorded an accrued liability of \$631,000, representing management's current best estimate of the cost of resolving all the matters noted above.

24 Reconciliation to accounting principles generally accepted in the United States of America

Reconciliation of net loss

The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States, except for the following:

	2001	2000	1999
	\$	\$	\$
Loss for the year under Canadian GAAP	19,871,231	6,940,356	2,196,785
Compensation cost (recovery) (i)	(179,006)	2,125,216	352,850
Amortization cost (recovery) (ii)	-	(108,160)	-
	<hr/>	<hr/>	<hr/>
Loss for the year under US GAAP	19,692,225	8,957,412	2,549,635
	<hr/>	<hr/>	<hr/>
Basic and diluted loss per share under US GAAP (iv)	(0.59)	(0.36)	(0.21)
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Had the company followed US GAAP, the balance sheet within the consolidated financial statements would have been reported as follows:

	2001		2000 ¹	
	Canadian GAAP \$	US GAAP \$	Canadian GAAP \$	US GAAP \$ (restated)
Assets				
Current assets	130,975	130,975	7,624,735	7,624,735
Property, plant and equipment	1,357,301	1,357,301	5,388,902	5,388,902
Intangible assets	-	-	2,702,300	2,702,300
	1,488,276	1,488,276	15,715,937	15,715,937
Liabilities				
Current liabilities	6,615,787	6,615,787	1,683,306	1,683,306
Long term capital lease obligations	-	-	368,499	368,499
Shareholders' (Deficit)/ Equity (i), (ii)	(5,127,511)	(5,127,511)	13,664,132	13,664,132

¹Correction of reconciliation information

The company has restated certain tabular information disclosed previously for the balance sheet presented under US GAAP as it was presented incorrectly in US dollars.

Reconciliation between Canadian GAAP and US GAAP statement of shareholders' equity

	Common stock	Contributed surplus \$	Convertible notes	Special/agent's warrants	Warrants	Deferred compensation \$	Deficit \$	Total shareholders' equity \$
Balance - September 30, 1999								
Canadian GAAP	9,925,892	42,930	31,250	-	-	-	(10,300,417)	(300,345)
US GAAP	9,925,892	395,780	31,250	-	-	-	(10,653,267)	(300,345)
Balance - September 30, 2000								
Canadian GAAP	16,315,246	59,857	-	9,105,302	5,847,500	(423,000)	(17,240,773)	13,664,132
US GAAP	16,207,086	2,537,923	-	9,105,302	5,847,500	(423,000)	(19,610,679)	13,664,132
Balance - September 30, 2001								
Canadian GAAP	24,168,231	5,927,262	-	-	2,150,000	(261,000)	(37,112,004)	(5,127,511)
US GAAP	24,060,071	8,226,322	-	-	2,150,000	(261,000)	(39,302,904)	(5,127,511)

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	2001 \$	2000 \$	1999 \$
Cash flows from operating activities			
Loss for the year under US GAAP	(19,692,225)	(8,957,412)	(2,549,635)
Items not affecting cash			
Compensation cost (recovery) (i)	179,006	2,125,216	352,850
Amortization cost (recovery) (ii)	-	(108,160)	-
Changes in non-cash working capital and items not affecting cash	12,407,128	(408,586)	21,471
Operating activities under US GAAP	(7,106,091)	(7,348,942)	(2,175,314)
Cash flows from financing activities under Canadian GAAP and US GAAP	1,693,345	18,892,590	2,364,195
Cash flows from investing activities under Canadian GAAP and US GAAP	189,480	(6,467,446)	(36,026)
(Decrease) increase in cash and cash equivalents	(5,223,266)	5,076,202	152,855
Cash and cash equivalents - Beginning of year	5,229,057	152,855	-
Cash and cash equivalents - End of year	5,791	5,229,057	152,855

i) Stock-based compensation

Under Canadian GAAP, the company does not measure compensation expense in connection with the granting or repricing of options.

Under US GAAP, the company applies APB Opinion 25, "Accounting for Stock Issued to Employees," and related interpretations in accounting for stock compensation to employees and directors. Under APB 25, because the exercise price of the company's employee stock options equals the market price of the underlying stock on the date of the grant, no compensation is recognized at the time of the initial grant. If the exercise price of a fixed stock option award is reduced after December 15, 1998, FASB Interpretation No. 44 (FIN 44) requires that the option award be accounted for as variable from the date of the modification to the date the award is exercised, forfeited or expires unexercised. Accordingly, the company records compensation expense or recovery for such modified options calculated as the amount of the change in the intrinsic value of the options from the time of the modification to the date the modified option is exercised, forfeited or expires.

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Statement of Financial Accounting Standards No. 123, "accounting for Stock-Based Compensation" (SFAS 123) requires the company to provide pro forma information regarding net income and earnings per share as if compensation for the company's stock option plans had been determined in accordance with the fair value based method prescribed in SFAS 123. The company estimates the fair value of each stock option at the grant date or measures variable compensation for options subject to modification and requiring variable accounting from the date of modification by using the Black-Scholes option-pricing model with the following weighted average assumptions used for grants in the year ended September 30, 2001: dividend yield of nil (2000 and 1999 - nil); expected volatility of 100% (2000 - 85% ;1999 67%); risk free interest rate of 4.00% (2000 - 5.33% ;1999 4.86%); and expected life of 5 years (2000 - 5 years; 1999 - 5 years). The fair value of options granted in the year was \$3,443,035 (1999 - \$9,508,658; 1998 - \$716,815).

Under the accounting provisions of SFAS 123, the company's US GAAP loss of \$19,692,225 would have been increased to a pro-forma loss of \$21,935,933 (2000 - \$16,340,854; 1999 - \$2,909,200) and a pro-forma basic and diluted loss per share of \$0.66 (1999 - \$0.66; 1998 - \$0.24).

ii) Amortization costs

Under Canadian GAAP, the company presents the convertible debenture in its component parts. These components are measured at their respective fair values at the time they were originally issued.

Under US GAAP the company applies APB Opinion 14 "Accounting for Convertible Debt" and related interpretations in accounting for convertible debentures. Under APB 14, no portion of the proceeds from the issuance of certain types of convertible debenture should be accounted for as attributable to the conversion feature.

iii) Comprehensive income

US GAAP requires disclosure of comprehensive income (loss), which is intended to reflect all changes in equity except those resulting from contributions from owners. There are no components of other comprehensive income therefore net loss equals comprehensive loss.

iv) Earnings per share

Outstanding options and warrants as described in note 11, with the exception of contingently issuable shares have not been included in the calculation of diluted earnings per share as their effect would be anti-dilutive. As such the basic and diluted earnings per share calculations do not differ.

v) Future income taxes

Under Canadian GAAP, future tax consequences are measured using enacted or substantially enacted tax rates. Under US GAAP, future tax consequences are measured using enacted tax rates. There is no material effect on these financial statements arising from this difference.

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vi) New financial accounting standards

In June 2001, the Financial Accounting Standards Board ("FASB") issued SFAS No. 141, Business Combinations, and SFAS No. 142, Goodwill and Other Intangible Assets. These new standards eliminate pooling as method of accounting for business combinations, and feature new accounting rules for goodwill and intangible assets. The Canadian Institute of Chartered Accountants has also issued similar recommendations. The company does not foresee any impact on a cumulative effect of an accounting change or on the carrying values of assets and liabilities recorded in the Consolidated Balance Sheet upon adoption. SFAS No. 141 is effective for business combinations initiated from July 1, 2001. SFAS No. 142 will be adopted on January 1, 2002.

Also issued in June 2001 was SFAS No. 143, Accounting for Asset Retirement Obligations. This Statement addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. It requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made. The associated asset retirement costs are capitalized as part of the carrying amount of the long-lived asset. The company does not expect the new standard to have any material impact.

In August 2001, the FASB issued SFAS No. 144, Accounting for the Impairment or Disposal of Long-lived Assets. This statement addresses accounting for discontinued operations and the impairment or disposal of long-lived assets. The company is analyzing the impact of SFAS No.144 and will adopt the standard on January 1, 2002.

In November 2001 the Accounting Standards Board of the Canadian Institute of Chartered Accountants issued new Handbook Section 3870, Stock-based Compensation and Other Stock-based Payments. This Section establishes standards for the recognition, measurement and disclosure of stock-based compensation and other stock-based payments made in exchange for goods and services. It applies to transactions, including non-reciprocal transactions, in which an enterprise grants shares of common stock, stock options, or other equity instruments, or incurs liabilities based on the price of common stock or other equity instruments and sets out a fair value based method of accounting which is required for certain, but not all, stock-based transactions. The company is analyzing the impact of Section 3870 and will adopt the Section on October 1, 2002.

25 Subsequent events

Special warrants

Between September 30, 2001 and March 5, 2002, the company issued 26,576,381 special warrants. Consideration included the conversion of debt, liabilities and advances outstanding as at September 30, 2001. Cash received on issuance was \$1,667,777. Each special warrant is exercisable to acquire, for no additional consideration, one common share and one common share purchase warrant. Each share purchase warrant will entitle the holder to acquire a further common share at a price of \$0.10 per share at any time on or before October 17, 2002. Each special warrant was deemed exercised on February 17, 2002, and the underlying common shares and warrants issued.

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Bankruptcy of US Subsidiary - PhotoChannel, Inc.

On November 1, 2001, PhotoChannel, Inc. filed under Chapter 7 of the United States Bankruptcy Code with the United States Bankruptcy Court, District of Connecticut. PhotoChannel, Inc. had been providing the e-processing service in the United States. As at September 30, 2001, the company has written off all assets associated with its subsidiary, PhotoChannel, Inc. and as of the date of filing under Chapter 7, the company will cease to consolidate the liabilities and results of operations of PhotoChannel, Inc., resulting in a recovery of amounts previously charged.

PhotoChannel Networks Limited Partnership

On February 14, 2002, the company formed PhotoChannel Networks Limited Partnership (PNLP). PNLP has commenced a private placement under which it proposes to raise \$1,000,000 from the issuance of 1,000 limited partnership units at a price of \$1,000 per unit. As at February 28, 2002, the company had received commitments for 420 units. PNI is the general partner of PNLP.