

PhotoChannel Networks Inc.

Consolidated Financial Statements
September 30, 2002, 2001 and 2000
(expressed in Canadian dollars)

Auditors' Report

To the Shareholders of PhotoChannel Networks Inc.

We have audited the consolidated balance sheets of **PhotoChannel Networks Inc.** as at September 30, 2002 and 2001 and the consolidated statements of loss and deficit, shareholders' equity (deficiency) and cash flows for each of the three years ended September 30, 2002. 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 United States 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, 2002 and 2001 and the results of its operations and its cash flows for each of the three years ended September 30, 2002 in accordance with Canadian generally accepted accounting principles.

“PricewaterhouseCoopers LLP”

Chartered Accountants

Vancouver, B.C., Canada
January 29, 2003

Comments by Auditor for U.S. Readers on Canada-U.S. 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 January 29, 2003 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
January 29, 2003

Celebrating 90 years in British Columbia

PhotoChannel Networks Inc.

Consolidated Balance Sheets

As at September 30, 2002 and 2001

(expressed in Canadian dollars)

	2002 \$	2001 \$
Assets		
Current assets		
Cash and cash equivalents	85,586	6,017
Short-term deposits	15,000	10,187
Accounts receivable (note 4)	117,685	88,004
Prepaid expenses (note 5)	34,967	26,767
	<u>253,238</u>	<u>130,975</u>
Property, plant and equipment (note 6)	455,999	1,357,301
	<u>709,237</u>	<u>1,488,276</u>
Liabilities		
Current liabilities		
Accounts payable (note 7)	2,324,905	4,483,316
Accrued liabilities	256,556	701,954
Due to related parties	273,612	-
Advance on private placement	-	508,873
Obligation under capital leases (note 10)	-	453,658
Demand loan (note 8)	-	467,986
	<u>2,855,073</u>	<u>6,615,787</u>
Shareholders' Deficiency		
Capital stock (note 11a)		
Issued and outstanding		
77,894,968 (2001 - 41,776,587) common shares without par value	26,390,849	24,168,231
Contributed surplus	6,189,605	5,927,262
Loans receivable (note 11e)	(227,470)	-
Warrants (note 11d)	3,214,845	2,150,000
Limited partnership equity (note 12)	1,250,000	-
Deferred compensation (note 11d)	-	(261,000)
Deficit	(38,963,665)	(37,112,004)
	<u>(2,145,836)</u>	<u>(5,127,511)</u>
	<u>709,237</u>	<u>1,488,276</u>
Nature of operations and going concern (note 1)		
Contingencies (note 20)		
Subsequent events (note 22)		

Approved by the Board of Directors

"Peter Scarth" Director

"Cory Kent" Director

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

PhotoChannel Networks Inc.

Consolidated Statements of Shareholders' Equity (Deficiency) For the years ended September 30, 2002, 2001 and 2000

(expressed in Canadian dollars)

	Common stock				Other capital accounts						Total shareholders' equity / (deficiency) \$
	Number of shares	Amount \$	Contributed surplus \$	Convertible notes / Loans receivable \$	Special warrants	Amount \$	Limited partnership Units	Amount \$	Deferred compensation \$	(Deficit) retained earnings \$	
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	-	1,700,000	-	-	1,700,000
Issuance of warrants	-	-	-	-	-	1,000,000	-	450,000	(450,000)	-	-
Vesting of warrants	-	-	-	-	-	-	-	-	27,000	-	27,000
Private placement of special 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)	-	(960,000)	-	(22,019)	-	-	1,025,000
Shares issued on exercise of warrants	960,000	1,047,019	-	-	-	-	-	-	-	(6,940,356)	(6,940,356)
Net loss for the year	-	-	-	-	-	-	-	-	-	-	-
Balance - September 30, 2000	29,865,766	16,315,246	59,857	-	11,000,000	9,105,302	-	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
Issuance of options in exchange for services provided	-	-	44,000	-	-	-	-	-	-	-	44,000
Vesting of warrants	-	-	-	-	-	-	-	-	162,000	-	162,000
Shares and warrants issued on conversion of special warrants	11,000,000	6,979,397	-	-	(10,000,000)	(9,028,802)	-	2,049,405	-	-	-
Expiry of warrants	-	-	2,770,780	-	-	(2,500,000)	-	(2,770,780)	-	-	-
Expiry of warrants	-	-	2,049,405	-	-	(3,500,000)	-	(2,049,405)	-	-	-
Expiry of agents warrants	-	-	76,500	-	(1,000,000)	(76,500)	-	-	-	-	-
Net loss for the year	-	-	-	-	-	-	-	-	-	(19,871,231)	(19,871,231)
Balance - September 30, 2001	41,776,587	24,168,231	5,927,262	-	-	-	-	2,150,000	(261,000)	(37,112,004)	(5,127,511)
Issuance of options in exchange for services provided	-	-	73,343	-	-	-	-	-	-	-	73,343
Issuance of warrants in exchange for services provided	-	-	-	-	-	-	-	125,625	-	-	125,625
Expiry of warrants	-	-	189,000	-	-	5,025,000	-	(450,000)	261,000	-	-
Private placement of 26,576,381 special warrants	-	-	-	-	26,576,381	2,657,638	-	-	-	-	2,657,638
Employee loan	-	-	-	(227,470)	-	-	-	-	-	-	(227,470)
Shares and warrants issued on conversion of special warrants	26,576,381	1,575,176	-	-	(26,576,381)	(2,657,638)	-	1,082,462	-	-	-
Private placement of 8,542,000 units	8,542,000	503,953	-	-	-	8,542,000	-	350,247	-	-	854,200
Shares issued on exercise of warrants	1,000,000	143,489	-	-	-	(1,000,000)	-	(43,489)	-	-	100,000
Issuance of Limited Partnership units	-	-	-	-	-	-	1,250	1,250,000	-	-	1,250,000
Net loss for the year	-	-	-	-	-	-	-	-	-	(1,851,661)	(1,851,661)
Balance - September 30, 2002	77,894,968	26,390,849	6,189,605	(227,470)	-	37,457,382	-	3,214,845	-	(38,963,665)	(2,145,836)

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

PhotoChannel Networks Inc.

Consolidated Statements of Loss and Deficit

For the years ended September 30, 2002, 2001 and 2000

(expressed in Canadian dollars)

	2002 \$	2001 \$	2000 \$
Revenue	173,801	97,112	126,313
Cost of sales	111,670	126,036	10,810
Gross profit (loss)	62,131	(28,924)	115,503
Expenses (note 14)			
Amortization	890,387	2,428,873	283,167
Impairment write down	-	4,806,390	-
General and administration	3,108,488	9,331,167	5,313,692
Sales and marketing	654,256	2,142,640	681,730
Research and development	614,484	1,411,628	872,031
Interest expense	129,188	110,125	120,676
	5,396,803	20,230,823	7,271,296
	(5,334,672)	(20,259,747)	(7,155,793)
Interest and miscellaneous income	2,193	52,210	215,437
Gain on bankruptcy of subsidiary (Note 14)	2,746,944	-	-
Gain on settlement of obligations (note 14)	808,774	66,382	-
Translation (loss) gain	(74,900)	269,924	-
Net loss for the year	(1,851,661)	(19,871,231)	(6,940,356)
Deficit - Beginning of year	(37,112,004)	(17,240,773)	(10,300,417)
Deficit - End of year	(38,963,665)	(37,112,004)	(17,240,773)
Basic and diluted net loss per share attributable to common shareholders	0.03	0.60	0.32
Weighted average number of common shares outstanding	59,479,315	33,187,579	21,873,716

Nature of operations and going concern (note 1)

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

PhotoChannel Networks Inc.
Consolidated Statements of Cash Flows
For the years ended September 30, 2002, 2001 and 2000

(expressed in Canadian dollars)

	2002	2001	2000
	\$	\$	\$
Cash flows from operating activities			
Net loss for the year	(1,851,661)	(19,871,231)	(6,940,356)
Items not affecting cash			
Amortization	890,387	2,428,873	283,167
Impairment write down	-	4,806,390	-
Loss on sale of property, plant and equipment	386	53,144	-
Issuance of options and warrants for goods and services received	198,968	206,000	27,000
Interest accretion on convertible debenture	-	-	108,160
	(761,920)	(12,376,824)	(6,522,029)
Net change in non-cash working capital items (note 13)	(2,368,078)	5,270,733	(826,913)
	<u>(3,129,998)</u>	<u>(7,106,091)</u>	<u>(7,348,942)</u>
Cash flows from investing activities			
Purchase of property, plant and equipment	(1,882)	(1,186,256)	(4,710,973)
Short term deposits	(4,813)	743,986	(754,173)
Deferred website development costs	-	-	(1,002,300)
Proceeds from sale of property, plant and equipment	12,411	631,750	-
	<u>5,716</u>	<u>189,480</u>	<u>(6,467,446)</u>
Cash flows from financing activities			
Repayment on capital lease	(453,658)	(156,876)	-
Issuance of common shares and warrants	854,200	-	6,124,789
Issuance of common shares on exercise of warrants and options	100,000	873,588	1,025,000
Issue (repayment) of demand loan	(467,986)	467,986	-
Issuance of convertible debentures	-	-	2,700,000
Repayment of convertible debentures	-	-	(62,501)
Issuance of limited partnership units	1,250,000	-	-
Issuance of special warrants	1,921,295	508,873	9,105,302
	<u>3,203,851</u>	<u>1,693,571</u>	<u>18,892,590</u>
Increase (decrease) in cash and cash equivalents	79,569	(5,223,040)	5,076,202
Cash and cash equivalents - Beginning of year	6,017	5,229,057	152,855
Cash and cash equivalents - End of year	85,586	6,017	5,229,057
Supplementary information			
Interest paid	-	-	120,676
Non-cash investing and financing activities consist of:			
Obligation under capital leases	-	-	610,534
Shares issued on conversion of special warrants	1,575,176	6,979,397	-
Warrants issued on conversion of special warrants	1,082,462	2,049,405	-
Warrants issued in exchange for capitalized web site development	-	-	1,700,000
Conversion of convertible debenture to shares	-	-	2,814,582
Settlement of debt	227,470	-	-

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

PhotoChannel Networks Inc.

Notes to the Financial Statements

For the years ended September 30, 2002, 2001 and 2000

(expressed in Canadian dollars)

1 Nature of operations and going concern

PhotoChannel Networks Inc. (the company) was incorporated on December 1, 1995 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. On October 2, 2000 the company launched a second version of the website which included an e-Processing service in the United States. This e-Processing service, operated by the company's US operating subsidiary, PhotoChannel, Inc., provided film processing, scanning, storage and printing of digital images directly to US consumers. This service did not prove viable, and PhotoChannel, Inc. was unable to continue as an operating entity. 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 (the accounting impact of this filing is set out in note 14).

On March 16, 2001, the company was restructured under new management. Under the restructuring plan, new management refocused and repositioned the company to be a business to business solution rather than a business to consumer model, which had been offered by PhotoChannel, Inc. The company implemented significant cost reduction measures such as: elimination of staff, relocation of premises, significant reductions in travel and marketing expenses and the elimination of an investor relations program. The company's technology was refocused and further developed to provide an e-commerce and Internet infrastructure solutions to photo-finishing retailers. The PhotoChannel Network now electronically connects the photo-finishing retailer and its customers through the Internet and provides digital image delivery, hosting, storage and financial reporting for the photo-finishing retailer.

At September 30, 2002, the company has an accumulated deficit of \$38,963,665 (2001 - \$37,112,004) and has incurred significant losses in each of its last five fiscal years. During the year ended September 30, 2002 the company used cash of approximately \$3,130,000 (2001 - \$7,106,000) to fund operations whilst obtaining approximately \$3,204,000 (2001 - \$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. These consolidated financial statements have been prepared on a going concern basis. 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.

Management is implementing a plan to address these issues and to enable the company to continue as a going concern through the end of fiscal year 2003 and beyond. This plan includes obtaining debt or equity financing in amounts sufficient to sustain operations, expand the company's customer base and the subsequent realization of sufficient revenues produced by this network. Subsequent to the year end the company raised cash of approximately \$1,507,000 (see note 22). However, there is only a limited operating history with the existing business model, and there is no assurance that the necessary financing can be obtained or on what terms it may be obtained. The accompanying financial statements do not include any adjustments to reflect the possible

PhotoChannel Networks Inc.

Notes to the Financial Statements

For the years ended September 30, 2002, 2001 and 2000

(expressed in Canadian dollars)

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 wholly owned or controlled subsidiaries, PhotoChannel Capital Inc., PhotoChannel Management Inc. and PhotoChannel Networks Limited Partnership. All intercompany balances and transactions are eliminated upon consolidation.

Research and development

Research costs are expensed in the period incurred. Where, in the opinion of management, the deferral criteria established under Canadian GAAP are satisfied in all material respects, development costs are capitalized and amortized over the estimated life of the related products. To date no development costs have been deferred.

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

Tangibles assets are tested for impairment in value on a regular basis and the carrying value is written down if management concludes that future earnings are unlikely to be sufficient to recover the carrying value or if there is sufficient uncertainty in future earnings attributable to the tangible asset such that no such reasonable estimate of earnings can be made.

Revenue recognition

Revenue is recognized when all of the following criteria have been met: persuasive evidence of an arrangement exists; the services have been provided; the price is fixed or determinable; customer acceptance has been received or implied; and the collection of sales proceeds is reasonably assured.

During fiscal year 2002, the company earned commission and membership revenue from the provision of the PhotoChannel Network to electronically connect photo-finishing retailers to customers through the Internet. Revenue from monthly membership fees from photo-finishing retailers for the connection to the PhotoChannel Network is earned and recognised monthly as connection is provided. Revenue from commissions earned on transactions processed by the photo-finishing retailers, utilising the PhotoChannel Network, is recognized at the time the digital image processing services are provided to the end customer.

PhotoChannel Networks Inc.

Notes to the Financial Statements

For the years ended September 30, 2002, 2001 and 2000

(expressed in Canadian dollars)

During the fiscal year ended September 30, 2001 the company through its US subsidiary, PhotoChannel, Inc., also earned revenue from the direct provision of e-processing services providing film processing, scanning, storage and printing of digital images directly to US consumers. These revenues were recognised upon the collection of proceeds, at the time the digital image processing services were 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.

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 11 (b). 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 is 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.

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.

Net loss per share

Net loss per share figures are calculated using the weighted average number of shares outstanding during the year.

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. Exchange differences are included in income as they arise.

Use of estimates and measurement uncertainty

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

PhotoChannel Networks Inc.

Notes to the Financial Statements

For the years ended September 30, 2002, 2001 and 2000

(expressed in Canadian dollars)

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 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.

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.

3 Short-term deposits

Short-term deposits consist 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, at maturity, for their face value plus accrued interest, and therefore, the carrying value approximates their fair value.

4 Accounts receivable

	2002	2001
	\$	\$
Trade accounts receivable	40,012	-
GST receivable	77,653	70,058
Other	20	17,946
	<hr/>	<hr/>
	117,685	88,004
	<hr/>	<hr/>

PhotoChannel Networks Inc.

Notes to the Financial Statements

For the years ended September 30, 2002, 2001 and 2000

(expressed in Canadian dollars)

5 Prepaid expenses

	2002 \$	2001 \$
Prepaid consulting	17,900	-
Prepaid rent, insurance, miscellaneous	17,067	26,767
	<u>34,967</u>	<u>26,767</u>

6 Property, plant and equipment

	2002			
	Cost \$	Accumulated amortization \$	Impairment write-down \$	Net \$
Computer equipment	2,852,597	2,411,443	-	441,154
Furniture and office equipment	152,428	138,774	-	13,654
Software	204,101	204,101	-	-
Leasehold improvements	56,459	55,268	-	1,191
	<u>3,265,585</u>	<u>2,809,586</u>	-	<u>455,999</u>

Included in the above are assets under capital leases relating to computer equipment, with a cost of \$nil (2001 - \$789,299) and a net book value of \$nil (2001 - \$533,940). Assets with a cost of \$3,086,754 and net book value of \$nil were eliminated on the bankruptcy of PhotoChannel, Inc.

	2001			
	Cost \$	Accumulated amortization \$	Impairment write-down \$	Net \$
Computer equipment	3,885,866	1,166,727	1,417,262	1,301,877
Furniture and office equipment	665,402	109,310	501,724	54,368
Software	491,396	491,396	-	-
Leasehold improvements	1,321,758	234,831	1,085,871	1,056
	<u>6,364,422</u>	<u>2,002,264</u>	<u>3,004,857</u>	<u>1,357,301</u>

PhotoChannel Networks Inc.

Notes to the Financial Statements

For the years ended September 30, 2002, 2001 and 2000

(expressed in Canadian dollars)

7 Accounts Payable

	2002 \$	2001 \$
Trade payables	1,395,568	3,502,428
Payroll taxes	478,899	740,657
Due to employees and consultants	450,438	240,231
	<hr/> 2,324,905	<hr/> 4,483,316

8 Demand loan

The demand loan bears interest at 12% per annum and is collateralized by a general security agreement over the assets of the company and its subsidiaries. All outstanding amounts were settled during the year ended September 30, 2002.

9 Convertible debentures

- a) The company issued a convertible debenture on March 1, 1998. The debenture had a five-year term and would have matured on 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.
- 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. After May 1, 2000, the interest rate was 25% per annum. The debenture was converted into common shares of the company at a rate of \$0.50 per share at the option of the holder on May 9, 2000.

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 was included in interest expense.

- c) On January 12, 2000, the company issued a subordinated convertible redeemable debenture for \$2,300,000. The amounts were advanced at specified dates with the last instalment on April 14, 2000. The debenture was non-interest bearing and matured on April 30, 2000. The debenture was convertible at either party's discretion into common shares of the company at a rate of \$0.50 per common share. As part 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

PhotoChannel Networks Inc.

Notes to the Financial Statements

For the years ended September 30, 2002, 2001 and 2000

(expressed in Canadian dollars)

\$1.25. The warrants were to expire on June 30, 2000, but were exercised to acquire common shares of the company at the option of the holder at that date.

The subordinated convertible redeemable debenture was originally recorded as a component of equity because of the company's right to convert the debenture into common shares of the company.

10 Obligation under capital lease

The company had leased computer and office equipment under agreements bearing interest at a rate of 18.6%.

11 Capital stock, special warrants and warrants

a) Capital stock

Common Shares

Authorized

500,000,000 (2001 - 500,000,000; 2000 - 500,000,000) common shares without par value

Issued

77,894,968 (2001 - 41,776,587; 2000 - 29,865,766) 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.

Preferred Shares

Authorized

10,000,000 (2001 - 10,000,000; 2000 - nil) preferred shares without par value

Issued

nil (2001 - nil; 2000 - nil) preferred shares without par value

The shareholders of the company approved increasing the authorized capital of the Company and creating 10,000,000 Preferred shares without par value by way of a special resolution at an extraordinary general meeting on January 26, 2001.

- i) Pursuant to a non-brokered private placement during the year ended September 30, 2002, the company issued 8,542,000 units for net proceeds of \$854,200. Each unit consisted of one common share and one common share purchase warrant. Each common share purchase warrant entitles the holder to purchase one additional common share of the company at a price of \$0.10 per share for a period of one year from the date of closing. During the year ended September 30, 2002, none of these common share purchase warrants had been exercised.

PhotoChannel Networks Inc.

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- ii) Pursuant to a non-brokered private placement during the year ended September 30, 2002, the company issued 26,576,381 special warrants for net proceeds of \$2,657,638. The special warrants were subsequently converted to 26,576,381 common shares and 24,890,381 common share purchase warrants. Each common share purchase warrant entitled the holder to purchase one additional common share of the company at a price of \$0.10 per share for a period of one year from the date of closing. During the year ended September 30, 2002, 1,000,000 of these common share purchase warrants were exercised for net proceeds of \$100,000.
- iii) Pursuant to private offerings and non-brokered portion of a private placement 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 entitled the holder to convert each common share purchase 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 common share purchase warrants expired unexercised on August 9, 2001.

b) Stock Options

During 1997, the company initiated a stock option plan. As at September 30, 2002, the company has reserved 13,600,000 common shares (2001 – 10,444,146; 2000 - 9,932,000) under the plan. The options, which expire five years after the date granted, are subject to various vesting requirements. Under the original terms of the plan, 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. However at an extraordinary general meeting of the company's shareholders held on December 7, 2001, the stock option plan was amended in that the vesting period changed to 1/18 of the options granted vesting each month, with the first portion vesting on date of grant.

During the year ended September 30, 2002, the exercise price of 1,889,709 options originally granted between 1998 and 2000 was reduced from a range of \$1.57 to \$0.50 per option to \$0.15 per option. During the year ended September 30, 2001 1,649,000 options originally granted in 1998 and 1999 with an exercise price of \$1.91 per share were cancelled and replaced by options with an exercise price of US\$1.00 per share.

During the years ended September 30, 2002 and 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 was charged as an expense in the period.

A summary of the status of the company's stock option plan as of September 30, 2002, 2001 and 2000 and changes in the periods ending on those dates is presented below:

PhotoChannel Networks Inc.

Notes to the Financial Statements

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(expressed in Canadian dollars)

	2002		2001		2000	
	Shares	Weighted average exercise price \$	Shares	Weighted average exercise price \$	Shares	Weighted average exercise price \$
Outstanding - Beginning of year	9,520,189	0.66	9,843,520	1.46	3,138,000	0.56
Granted	6,299,611	0.15	9,303,058	0.70	10,519,686	1.63
Exercised	-	-	(74,667)	0.50	(1,024,433)	0.50
Expired	(15,000)	1.47	-	-	-	-
Cancelled	<u>(2,465,480)</u>	1.20	<u>(9,551,722)</u>	1.39	<u>(2,789,733)</u>	0.59
Outstanding - End of year	<u>13,339,320</u>	0.15	<u>9,520,189</u>	0.66	<u>9,843,520</u>	1.46
Options exercisable - End of year	<u>7,023,490</u>	0.19	<u>5,050,397</u>	0.83	<u>4,418,106</u>	1.26

The following table summarizes information about stock options outstanding at September 30, 2002:

Exercise prices \$	Options outstanding		Options exercisable	
	Number outstanding at September 30, 2002	Weighted average remaining contractual life (years)	Number exercisable at September 30, 2002	
0.15	13,139,320	3.6	6,823,490	
US1.00	<u>200,000</u>	2.8	<u>200,000</u>	
	<u>13,339,320</u>	3.6	<u>7,023,490</u>	

c) Special warrants

- i) On October 17, 2001, the company received conditional approval with the regulatory authorities for an offering of 26,576,381 special warrants at a price of \$0.10 per special warrant. Each special warrant, other than certain special warrants to be issued to insiders, was exercisable into one unit consisting of one common share and one common share purchase warrant. 1,686,000 of the special warrants were issued to insiders who were not entitled to the common share purchase warrant. Each common share purchase warrant entitled the holder to acquire one additional common share for \$0.10

PhotoChannel Networks Inc.

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per share. The common share purchase warrants expired one year after issuance. During the year ended September 30, 2002, 26,576,381 special warrants were exercised, and accordingly, 26,576,381 common shares and 24,890,391 common share purchase warrants were issued.

- ii) 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 in the capital of the company and one half of one common share purchase warrant. Each whole common share purchase warrant entitled the holder to acquire a further common share at a price of \$1.30 per common 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 common shares and common share purchase warrants on exercise of the special warrants, and (ii) August 9, 2000. The company did not obtain Receipts for the Prospectus before August 9, 2000, therefore each special warrant entitled the holder thereof to receive 1.1 common shares and 0.55 common share purchase warrants. During the year ended September 30, 2001, the special warrants were converted to 11,000,000 common shares and 5,500,000 common share purchase warrants for no additional compensation. The proceeds of the issuance of the special warrants was allocated to the common shares and common share purchase warrants according to the pro-rated fair value of the common shares and the common share purchase warrants at the date of issuance of the special warrants. The common share purchase warrants expired unexercised on August 9, 2001.

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 common share 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 common share purchase warrant. The common share purchase warrants expired unexercised on August 9, 2001. Funds raised from this non-brokered portion are included in the amounts disclosed in note 11(a)(iii).

d) Warrants

- i) During the year ended September 30, 2002, the company retained Discovery Capital Corporation (Discovery) to provide financial advisory services to the company, under an agreement dated February 19, 2002 (Agreement). As consideration under the Agreement, the company had agreed to issue Discovery 5,000,000 common share purchase warrants. On July 26, 2002, the TSX Venture Exchange, Discovery and the company agreed to the issuance of 4,325,000 common share purchase warrants, with an immediate vesting, as full consideration under the Agreement. The common share

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purchase warrants were issued on July 26, 2002 and are exercisable on or before July 26, 2004, at a price of \$0.10. Also during fiscal 2002, the company issued Discovery a finders fee of 700,000 common share purchase warrants (Finders Warrants), on the private placement of units of the PhotoChannel Networks Limited Partnership. The Finder Warrants are exercisable on or before July 26, 2004, at a price of \$0.10. The common share purchase warrants were assigned a value of \$125,625, which has been included as an expense and recorded in equity. The value was determined 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 2 years.

- ii) During the year ended September 30, 2000, the company retained Interactive Capital Partners LLC (Interactive) to provide financial advisory services to the company in the United States. As consideration under the agreement, and subject to regulatory approval, the company had agreed to issue Interactive 1,000,000 common share purchase warrants. Vested common share purchase warrants were 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 common share. The common share purchase warrants vested as to 30,000 per month commencing August 1, 2000 subject to the additional common share purchase warrants vesting in the event that the company completed a merger or acquisition introduced to the company by Interactive. The agreement expired on June 30, 2002 but could have been terminated by either party on 30 days notice. 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 common share purchase warrants. The outstanding value attributed to the cancelled common share purchase warrants was transferred to contributed surplus.

During the year ended September 30, 2002, nil common share purchase warrants vested (2001 – 360,000, 2000 - 60,000) and were assigned a value of \$nil (2001 - \$162,000, 2000 - \$27,000), which has been included as an expense and recorded in equity. The value of the common share purchase 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.

- iii) 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 common share purchase 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. The company has never used the software.

The MCL common share purchase warrant has been assigned a value of \$1,700,000, which has been included as a component of the website development costs and recorded in equity. The value of the common share purchase warrant was determined using the Black-Scholes option pricing model using

PhotoChannel Networks Inc.

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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.

e) Loans receivable

During the year ended September 30, 2002 the company made loans to employees, which were secured by common shares of the company. As at September 30, 2002 loans totalling \$227,470 were outstanding and have been recorded as a charge to shareholders equity. The loans are non-interest bearing and are repayable on demand.

12 PhotoChannel Networks Limited Partnership

On February 14, 2002, PhotoChannel Networks Limited Partnership (the "PhotoChannel LP") was formed under a Limited Partnership Agreement to carry on the sales, marketing and deployment of the PhotoChannel Network in specified market segments. The partnership sold 1,250 Limited Partnership units (the "LP Units"), at a price of \$1,000 per unit, raising \$1,250,000. The company has granted to the PhotoChannel LP a software license to commercially exploit the PhotoChannel Network in Canada. The company will receive payments for services provided to the PhotoChannel LP from a software license agreement and management and operating services agreements (representing software rights, management, personnel and facilities and equipment that the company has agreed to provide to the PhotoChannel LP), which will enable the company to continue its development, deployment and exploitation of its digital imaging network software in other market segments.

It was a condition of the PhotoChannel LP that each limited partner enter into an agreement with the company, pursuant to which the company has the option to acquire all the LP Units from the limited partner, at any time on or before June 30, 2004, in exchange for 10,000 units of the company. Each unit comprised of one common share and one common share purchase warrant. Each common share purchase warrant will entitle the holder to purchase one additional common share of the company, at a price of \$0.10 per share, at any time on or before the earlier of two years from the date of issue of the PhotoChannel units and June 30, 2004. As a result of this option, the common ownership of the company and the LP units and the fact that the company's controls the PhotoChannel LP, the partnership equity is presented within shareholders' equity of the company and, the accounts of the partnership have been consolidated with those of the company.

13 Net change in non-cash working capital items

	2002	2001	2000
	\$	\$	\$
Accounts receivable	(29,681)	507,583	(595,587)
Inventory	-	40,822	(19,995)
Prepaid expenses	(8,200)	978,329	(992,620)
Accounts payable	(2,158,411)	3,148,795	730,138
Accrued liabilities	(445,398)	595,204	51,151
Due to related parties	273,612	-	-
	<u>(2,368,078)</u>	<u>5,270,733</u>	<u>(826,913)</u>

PhotoChannel Networks Inc.

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For the years ended September 30, 2002, 2001 and 2000

(expressed in Canadian dollars)

14 Expense detail

	2002 \$	2001 \$	2000 \$
General and administration			
Salaries and consulting	2,145,564	4,992,072	2,389,495
Accounting and legal	337,569	928,702	506,255
Investor relations	16,000	278,257	360,350
Office and miscellaneous	502,308	2,010,123	712,181
Share of previous partnership losses	-	347,326	1,110,417
Rent	106,661	721,543	234,994
Loss on disposal of property plant and equipment	386	53,144	-
	<hr/> 3,108,488	<hr/> 9,331,167	<hr/> 5,313,692
Sales and marketing			
Salaries and consulting	602,432	368,911	132,332
Printing, advertising and promotion	1,372	1,729,012	510,519
Miscellaneous	50,452	44,717	38,879
	<hr/> 654,256	<hr/> 2,142,640	<hr/> 681,730
Research and development			
Salaries and consulting	611,223	1,176,626	325,684
Website planning	-	205,986	519,518
Miscellaneous	3,261	29,016	26,829
	<hr/> 614,484	<hr/> 1,411,628	<hr/> 872,031

PhotoChannel Networks Inc.

Notes to the Financial Statements

For the years ended September 30, 2002, 2001 and 2000

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Gain on Bankruptcy of Subsidiary

On November 1, 2001, PhotoChannel, Inc., the Company's US operating subsidiary, filed under Chapter 7 of the United States Bankruptcy Code with the United States Bankruptcy Court, District of Connecticut. PhotoChannel, Inc.'s principal operations related to the provision of film processing, scanning, storage and printing of digital images directly to US consumers. The provision of this service did not prove viable, and PhotoChannel, Inc. was unable to continue as an operating entity. An expense recovery for the year ended September 30, 2002, of \$2,746,944 resulted from the bankruptcy of PhotoChannel, Inc.

Gain of settlement of Obligations

A gain on settlement of obligations of \$808,774 was recognised as a result of debt settlements with various creditors of PhotoChannel Networks Inc.

15 Income taxes

The company is subject to Canadian federal and provincial taxes.

The company has non-capital losses for Canadian income tax purposes of approximately \$17,782,329, 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	2,629,755
2009	861,274
	<hr/>
	17,782,329
	<hr/>

PhotoChannel Networks Inc.

Notes to the Financial Statements

For the years ended September 30, 2002, 2001 and 2000

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Net future income tax assets consist of the following:

	2002 \$	2001 \$	2000 \$
Net operating loss carryforwards	6,223,815	9,807,144	6,968,000
Property, plant and equipment	1,755,107	2,788,231	329,000
Share issue costs	69,533	92,711	149,000
	<hr/>	<hr/>	<hr/>
	8,048,455	12,688,086	7,446,000
Valuation allowance	(8,048,455)	(12,688,086)	(7,446,000)
	<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 is appropriate.

The income tax recovery for the year ended September 30, 2002 differs from the amount obtained by applying the applicable statutory income tax rates to loss before income taxes as follows:

	2002 \$	2001 \$	2000 \$
Combined statutory income tax rate	42%	45%	45%
	<hr/>	<hr/>	<hr/>
Income tax recovery based on combined statutory rate	777,698	8,942,054	3,123,000
Effect of US subsidiary Chapter 7 bankruptcy (note 14)	(5,229,535)	-	-
Effect of lower effective tax rate on losses of foreign subsidiaries	-	-	(150,000)
Effect of change in expected tax rates	(129,616)	(3,635,168)	-
Non-deductible expenses and other differences	(58,178)	(64,800)	174,000
Change in valuation allowance	4,639,631	(5,242,086)	(3,147,000)
	<hr/>	<hr/>	<hr/>
	-	-	-

16 Related party transaction

During the year ended September 30, 2002, the company accrued consulting fees of approximately \$180,833 (2001- \$111,042), to a company owned by a current director and officer. This amount remained unpaid at September 30, 2002, but was paid in full subsequent to the year end.

PhotoChannel Networks Inc.

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As at September 30, 2002, the Company has accrued a total of \$273,612 for wages and consulting fees due to officers and employees of the Company. These amounts remained unpaid at September 30, 2002, but were paid in full subsequent to the year end.

17 Segmented information

During the year ended September 30, 2002 the company obtained all of its revenue from the provision of the PhotoChannel Network to photo-finishing retailers. During the year ended September 30, 2001 the company obtained revenues from its e-processing operations, through the provision of film processing, scanning, storage and printing of digital images directly to US consumers, and the sale of its packaged multimedia presentation software. During the year ended September 30, 2000 the company obtained all of its revenue from the sale of its packaged multimedia presentation software. During all of the above periods, losses were attributable to the related segments. At September 30, 2002 and 2001, all of the company's sales were from the U.S. market and its property, plant and equipment were located in Canada.

18 Financial instruments

a) Fair values

The fair values of short term deposits, accounts receivable, bank indebtedness, accounts payable, accrued liabilities, lease obligations and demand loans approximate their carrying amounts due to the near-term maturity of these instruments.

b) Credit risk

The company does not have a significant exposure to any individual customer or counter party. The company does provide its services on credit in the normal course of conducting its business.

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.

19 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:

PhotoChannel Networks Inc.

Notes to the Financial Statements

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	\$
2003	47,934
2004	39,945
2005	-
2006	-
2007	-
	<hr/>
	87,879
	<hr/>

20 Contingencies

Other than as set out below, as of January 29, 2003 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.

1. 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.
2. 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 claims he is owed severance 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 an alleged guarantee of the terms of the employment contract by the company.

The company, PhotoChannel Inc. and Mr. Tesser negotiated the proposed terms of a settlement of this dispute, but negotiations broke down. On August 2, 2002, the company received notice from the American Arbitration Association that the arbitrator had ruled on the claim, in favour of the Claimant in the amount of US\$106,000. Management is of the view, therefore, that the maximum exposure to the company is (US)\$106,000. The company intends to defend itself against the enforcement of this ruling (note 22).

3. On March 3, 1999, the company received a letter from DATT Japan indicating that they had proceeded with legal action in the Japanese courts and for an order for payment. On September 10, 2001, the company's legal representative received a telephone call from an individual claiming that he represented DATT Japan and indicated that his client had received a judgment from a Japanese court against PhotoChannel for approximately \$99,000. The company intends to defend itself against the enforcement of this judgment.

PhotoChannel Networks Inc.

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(expressed in Canadian dollars)

- 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 \$132,770.63 plus interest, for the provision of text, photographs and services. The company is disputing the claim.

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

The financial statements have been prepared in accordance with Canadian generally accepted accounting principles (Canadian GAAP), which differ in certain respects from those principles and practices that the Company would have followed had its financial statements been prepared in accordance with accounting principles and practices generally accepted in the United States (US GAAP).

The reconciliation of the loss for the year based on Canadian GAAP to US GAAP is as follows:

	2002 \$	2001 \$	2000 \$
Net loss for the year under Canadian GAAP	1,851,661	19,871,231	6,940,356
Compensation cost (recovery) (i)	953	(179,006)	2,125,216
Amortization cost (recovery) (ii)	-	-	(108,160)
Net loss and comprehensive loss for the year under U.S. GAAP (iii)	1,852,614	19,692,225	8,957,412
Basic and fully diluted loss per share under U.S. GAAP (iv)	(0.03)	(0.59)	(0.36)
Cash flows from operating activities			
Loss for the year under U.S. GAAP	(1,852,614)	(19,692,225)	(8,957,412)
Items not affecting cash			
Compensation cost (recovery) (i)	953	(179,006)	2,125,216
Amortization cost (recovery) (ii)	-	-	(108,160)
Changes in non-cash working capital and items not affecting cash	(1,278,337)	12,765,140	(408,586)
Operating activities under U.S. GAAP	(3,129,998)	(7,106,091)	(7,348,942)
Cash flows from financing activities under Canadian GAAP and U.S. GAAP	3,203,851	1,693,571	18,892,590
Cash flows from investing activities under Canadian GAAP and U.S. GAAP	5,716	189,480	(6,467,446)
(Decrease) increase in cash and cash equivalents	79,569	(5,223,040)	5,076,202
Cash and cash equivalents - Beginning of year	6,017	5,229,057	152,855
Cash and cash equivalents - End of year	85,586	6,017	5,229,057

PhotoChannel Networks Inc.

Notes to the Financial Statements

For the years ended September 30, 2002, 2001 and 2000

(expressed in Canadian dollars)

There are no material adjustments that affect the company's balance sheet under US GAAP

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

	Common Stock (i)	Contributed surplus (ii)	Loan receivable	Special warrants	Warrants	LP Units	Deferred compen- sation	Deficit (i)/(ii)	Total shareholders equity
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)
Balance – September 30, 2002									
Canadian GAAP	26,390,849	6,189,605	(227,470)	-	3,214,845	1,250,000	-	(38,963,665)	(2,145,836)
US GAAP	26,282,689	8,489,618	(227,470)	-	3,214,845	1,250,000	-	(41,155,518)	(2,145,836)

i) Stock-based compensation

Under Canadian GAAP, the company does not measure compensation expense in connection with the granting of options to employees. Under U.S. 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 subsequently reduced, 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, is 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.

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 compensation for options modified 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, 2002: dividend yield of nil (2001 and 2000 – nil); expected volatility of 100% (2001 – 100%; 2000 – 85%); risk free interest rate of 4% (2001 – 4.00%; 2000 - 5.33%); and expected life of 5 years (2001 – 5 years; 2000 – 5 years). The fair value of options granted in the year was \$441,022 (2001 - \$3,443,035; 2000 - \$9,508,658). The fair value of options modified during the year was \$53,419 (2001 and 2000 – nil).

Under the accounting provisions of SFAS 123, the company's U.S. GAAP loss of \$1,852,614 would have been increased to a pro-forma loss of \$2,154,779 (2001 - \$21,935,933; 2000 - \$16,340,854) and a pro-forma basic and diluted loss per share of \$0.04 (2001 - \$0.66; 2000 - \$0.66).

PhotoChannel Networks Inc.

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(expressed in Canadian dollars)

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 U.S. 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 loss

U.S. 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 material adjustments required to present comprehensive income for the purposes of these consolidated financial statements

iv) Net loss per share

Outstanding options and warrants as described in note 11, with the exception that 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) New financial accounting standards

In July 2002, the Financial Accounting Standards Board issued SFAS No. 146, Accounting for Exit or Disposal Activities. SFAS No. 146 addresses the recognition, measurement, and reporting of costs that are associated with exit and disposal activities, including costs related to terminating a contract that is not a capital lease and termination benefits that employees who are involuntarily terminated receive under the terms of a one-time benefit arrangement that is not an ongoing benefit arrangement or an individual deferred-compensation contract. SFAS No. 146 supersedes Emerging Issues Task Force Issue No. 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring). SFAS No. 146 will be effective for exit or disposal activities of the Company that are initiated after December 31, 2002.

The company has determined that other recently issued Canadian and US accounting pronouncements will have no impact on adoption.

PhotoChannel Networks Inc.

Notes to the Financial Statements

For the years ended September 30, 2002, 2001 and 2000

(expressed in Canadian dollars)

22 Subsequent events

Common Share Purchase Warrants

Between September 30, 2002 and October 17, 2002, the company issued 8,257,100 common shares of the company for proceeds of \$825,710 upon exercise of warrants from the October 17, 2001 private placement of special warrants. There had been 1,000,000 common shares issued upon exercise of warrants from this private placement prior to September 30, 2002. On October 18, 2002, the remaining 15,633,281 warrants expired unexercised.

Arthur Tesser

Subsequent to the Arbitrator's Award on August 2, 2002 Arthur Tesser made petition to the Supreme Court of the State of New York – New York County seeking confirmation of the Arbitrator's Award. On October 25, 2002 the company received notice from the Supreme Court of the State of New York – New York County confirming the Award of the Arbitrator, which was granted on default. Management is of the view that the maximum exposure to the company is (US)\$106,000. The company intends to defend itself against the enforcement of this Award.

Private Placements

On October 29, 2002, the company announced that it plans to offer up to an additional 750 units in the PhotoChannel Networks Limited Partnership. The company issued 115 units for consideration of \$115,000, prior to December 31, 2002, in connection with this offering.

On November 14, 2002, the company announced that it had engaged Yorkton Securities to complete a financing of up to \$2,000,000.

On January 29, 2003, the company announced that it had received subscriptions and funds for a non-brokered private placement in the amount of \$566,947. These financings are subject to the approval of the TSX Venture Exchange.