

PhotoChannel Networks Inc.

Consolidated Financial Statements
September 30, 2004, 2003 and 2002
(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, 2004 and 2003 and the consolidated statements of shareholders' equity (deficiency), loss and deficit and cash flows for each of the years in the three-year period ended September 30, 2004. 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 generally accepted auditing standards in Canada. 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, 2004 and 2003 and the results of its operations and its cash flows for each of the years in the three-year period ended September 30, 2004 in accordance with generally accepted accounting principles in Canada.

PricewaterhouseCoopers LLP

Chartered Accountants

Vancouver, B.C., Canada
December 10, 2004

PhotoChannel Networks Inc.

Consolidated Balance Sheets

As at September 30, 2004 and 2003

(expressed in Canadian dollars)

	2004 \$	2003 \$
Assets		
Current assets		
Cash and cash equivalents	955,965	1,104,410
Cash held in trust (note 6)	-	345,000
Accounts receivable (note 3)	321,149	96,750
Prepaid expenses	18,239	19,364
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	1,295,353	1,565,524
Property, plant and equipment (note 4)	650,339	285,573
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	1,945,692	1,851,097
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities (note 5)	575,844	1,117,247
Deferred revenue	175,769	60,000
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	751,613	1,177,247
Shareholders' Equity		
Capital stock (note 6)	41,702,604	31,826,678
Contributed surplus	7,060,029	6,976,915
Loans receivable (note 6)	(17,600)	(122,206)
Warrants (note 6)	2,188,653	2,168,522
Deficit	(49,739,607)	(40,176,059)
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	1,194,079	673,850
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	1,945,692	1,851,097

Nature of operations and going concern (note 1)

Commitments and contingencies (note 15)

Approved by the Board of Directors

"Bart Copeland" Director _____ "Cory Kent" Director

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

PhotoChannel Networks Inc.

Consolidated Statements of Shareholders' Equity (Deficiency)

For the years ended September 30, 2004, 2003 and 2002

(expressed in Canadian dollars)

	Common stock				Other capital accounts								Total shareholders' equity (deficiency) \$
	Number of shares	Amount \$	Contributed surplus \$	Loans receivable \$	Number of special warrants	Amount \$	Number of warrants	Amount \$	Limited partnership units	Amount \$	Deferred compensation \$	Deficit \$	
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)
Issuance of options in exchange for services provided	-	-	73,343	-	-	-	-	-	-	-	-	-	73,343
Issuance of warrants in exchange for services provided	-	-	-	-	-	-	5,025,000	125,625	-	-	-	-	125,625
Expiry of warrants	-	-	189,000	-	-	-	(1,000,000)	(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)	24,890,381	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
Loss for the year	-	-	-	-	-	-	-	-	-	-	-	(1,851,661)	(1,851,661)
Loss for the year attributable to the Limited Partnership	-	-	-	-	-	-	-	-	-	(1,237,590)	-	1,237,590	-
Balance - September 30, 2002	77,894,968	26,390,849	6,189,605	(227,470)	-	-	37,457,382	3,214,845	1,250	12,410	-	(37,726,075)	(2,145,836)
Issuance of options in exchange for services provided	-	-	97,181	-	-	-	-	-	-	-	-	-	97,181
Issuance of warrants in exchange for services provided	-	-	-	-	-	-	4,100,000	198,000	-	-	-	-	198,000
Expiry of warrants	-	-	690,129	-	-	-	(15,883,281)	(690,129)	-	-	-	-	-
Private placement of 5,669,470 units	5,669,470	406,414	-	-	-	-	5,669,470	160,533	-	-	-	-	566,947
Private placement of 25,200,000 units	25,200,000	2,425,414	-	-	-	-	500,000	34,364	-	-	-	-	2,459,778
Shares issued on exercise of warrants	18,549,100	2,604,001	-	-	-	-	(18,549,100)	(749,091)	-	-	-	-	1,854,910
Issuance of Limited Partnership units	-	-	-	-	-	-	-	-	360	360,000	-	-	360,000
Employee loan	-	-	-	105,264	-	-	-	-	-	-	-	-	105,264
Loss for the year	-	-	-	-	-	-	-	-	-	-	-	(2,822,394)	(2,822,394)
Loss for the year attributable to the Limited Partnership	-	-	-	-	-	-	-	-	-	(372,410)	-	372,410	-
Balance - September 30, 2003	127,313,538	31,826,678	6,976,915	(122,206)	-	-	13,294,471	2,168,522	1,610	-	-	(40,176,059)	673,850
Issuance of shares for cash from exercised options	1,080,333	162,050	-	-	-	-	-	-	-	-	-	-	162,050
Private placement of 9,600,000 units	9,600,000	794,575	-	-	-	-	9,600,000	279,176	-	-	-	-	1,073,751
Shares and warrants issued on redemption of Limited Partnership units	16,100,000	4,242,000	-	-	-	-	13,650,000	2,269,063	(1,610)	-	-	(6,511,063)	-
Shares issued on exercise of warrants relating to Limited Partnership	13,150,000	3,500,949	-	-	-	-	(13,150,000)	(2,185,949)	-	-	-	-	1,315,000
Expiry of LP warrants	-	-	83,114	-	-	-	(500,000)	(83,114)	-	-	-	-	-
Shares issued on exercise of warrants	9,103,470	1,176,352	-	-	-	-	(9,103,470)	(259,045)	-	-	-	-	917,307
Employee loan	-	-	-	104,606	-	-	-	-	-	-	-	-	104,606
Loss for the year	-	-	-	-	-	-	-	-	-	-	-	(3,052,485)	(3,052,485)
Balance - September 30, 2004	176,347,341	41,702,604	7,060,029	(17,600)	-	-	13,791,001	2,188,653	-	-	-	(49,739,607)	1,194,079

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, 2004, 2003 and 2002

(expressed in Canadian dollars)

	2004 \$	2003 \$	2002 \$
Revenue (note 9)	763,140	255,573	173,801
Expenses			
Amortization	171,476	280,778	890,387
Network delivery (note 10)	327,189	111,691	157,810
General and administration (note 10)	1,421,419	1,621,568	3,191,536
Sales and marketing (note 10)	642,006	734,792	654,256
Research and development (note 10)	1,279,238	789,189	614,484
	<u>3,841,328</u>	<u>3,538,018</u>	<u>5,508,473</u>
	(3,078,188)	(3,282,445)	(5,334,672)
Interest and other income	6,775	263	2,193
Gain on bankruptcy of subsidiary (note 10)	-	-	2,746,944
Foreign exchange gain (loss)	18,928	2,189	(74,900)
Gain on settlement of obligations (note 10)	-	457,599	808,774
Net loss for the year	(3,052,485)	(2,822,394)	(1,851,661)
Loss attributed to Limited Partnership (note 7)	-	372,410	1,237,590
Net loss for the year attributed to common shareholders	(3,052,485)	(2,449,984)	(614,071)
Deficit - Beginning of year	(40,176,059)	(37,726,075)	(37,112,004)
Redemption of Limited Partnership units	(6,511,063)	-	-
Deficit - End of year	<u>(49,739,607)</u>	<u>(40,176,059)</u>	<u>(37,726,075)</u>
Basic and fully diluted net loss per share	<u>0.02</u>	<u>0.03</u>	<u>0.01</u>
Weighted average number of common shares	<u>148,741,599</u>	<u>89,448,942</u>	<u>59,479,315</u>
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, 2004, 2003 and 2002

(expressed in Canadian dollars)

	2004 \$	2003 \$	2002 \$
Cash flows from operating activities			
Net loss for the year attributed to common shareholders	(3,052,485)	(2,449,984)	(614,071)
Items not affecting cash			
Amortization	171,476	280,778	890,387
Loss attributed to Limited Partnership	-	(372,410)	(1,237,590)
Loss on sale of property, plant and equipment	-	44,209	386
Issuance of options and warrants for goods and services received	-	295,181	198,968
	<u>(2,881,009)</u>	<u>(2,202,226)</u>	<u>(761,920)</u>
Net change in non-cash working capital items (note 8)	(648,908)	(1,641,288)	(2,368,078)
	<u>(3,529,917)</u>	<u>(3,843,514)</u>	<u>(3,129,998)</u>
Cash flows from investing activities			
Purchase of property, plant and equipment	(536,241)	(264,123)	(1,882)
Sale (purchase) of short-term deposits	-	15,000	(4,813)
Proceeds from sale of property, plant and equipment	-	109,562	12,411
	<u>(536,241)</u>	<u>(139,561)</u>	<u>5,716</u>
Cash flows from financing activities			
Repayment of capital lease	-	-	(453,658)
Issuance of common shares and warrants	1,073,750	3,026,725	854,200
Decrease (increase) in cash held in trust	345,000	(345,000)	-
Issuance of common shares on exercise of warrants and options	2,394,357	1,854,910	100,000
Repayment of demand loan	-	-	(467,986)
Repayment of loans receivable	104,606	105,264	-
Issuance of Limited Partnership units	-	360,000	1,250,000
Issuance of special warrants	-	-	1,921,295
	<u>3,917,713</u>	<u>5,001,899</u>	<u>3,203,851</u>
(Decrease) increase in cash and cash equivalents	(148,445)	1,018,824	79,569
Cash and cash equivalents - Beginning of year	1,104,410	85,586	6,017
Cash and cash equivalents - End of year	<u>955,965</u>	<u>1,104,410</u>	<u>85,586</u>
Supplementary information			
Interest paid	51,657	113,719	129,188
Interest received	6,520	263	2,193
Non-cash activities consist of:			
Redemption of Limited Partnership units	6,511,023	-	-
Expiry of warrants	55,413	690,129	189,000
Issuance of common shares on exercise of warrants	1,716,416	749,091	43,489
Shares issued on conversion of special warrants	-	-	1,575,176
Warrants issued on conversion of special warrants	-	-	1,082,462
Settlement of debt	-	-	227,470

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

PhotoChannel Networks Inc.

Notes to Consolidated Financial Statements

For the years ended September 30, 2004, 2003 and 2002

(expressed in Canadian dollars)

1 Nature of operations and going concern

PhotoChannel Networks Inc. (the company), through the PhotoChannel Network, 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, 2004, the company has an accumulated deficit of \$49,739,607 (2003 - \$40,176,059; 2002 - \$37,726,075). During the year ended September 30, 2004, the company used cash of approximately \$3,530,000 (2003 - \$3,844,000; 2002 - \$3,130,000) to fund operations while obtaining approximately \$3,918,000 (2003 - \$5,002,000; 2002 - \$3,204,000) from financing activities. The company has capital requirements in excess of its currently available resources and is dependent upon the proceeds of future financings to further finance the development and implementation of its business objectives. While these consolidated financial statements have been prepared on the going concern basis, which assumes the realization of assets and the settlement of liabilities in the normal course of operations, there are conditions that cast substantial doubt on the validity of this assumption. 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 in the foreseeable future.

Management is implementing a plan to address these uncertainties and to enable the company to continue as a going concern through the end of fiscal year 2005 and beyond. This plan includes obtaining debt or equity financing in amounts sufficient to sustain operations, expanding the company's customer base, and increasing revenues from operations. 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, which may be material, 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.

2 Significant accounting policies

Basis of consolidation

These consolidated financial statements are prepared in accordance with generally accepted accounting principles (GAAP) in Canada, and include the accounts of the company and each of its wholly owned or controlled subsidiaries, PhotoChannel Capital Inc. and PhotoChannel Management Inc.

The consolidated financial statements also included the accounts of PhotoChannel Networks Limited Partnership (the PhotoChannel LP) for all periods that the PhotoChannel LP was in existence up until the redemption of the Limited Partnership units in April 2004 (note 7). The accounts of the PhotoChannel LP had been consolidated in view of the existence of the company's option to acquire the PhotoChannel LP units from the limited partners and certain common ownership and management of the company and the PhotoChannel LP.

PhotoChannel Networks Inc.

Notes to Consolidated Financial Statements

For the years ended September 30, 2004, 2003 and 2002

(expressed in Canadian dollars)

All material 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 GAAP are satisfied in all material respects, development costs are capitalized and amortized over the estimated life of the related products. Otherwise, development costs are charged as an expense in the period incurred. 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 is charged over the estimated useful lives of the assets at the following annual rates:

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

The company assesses the carrying value of long-lived assets for recoverability whenever events or changes in circumstances indicate that the carrying value may not be recoverable from future undiscounted cash flows. An impairment loss equal to the difference in the asset carrying value and its fair value is recognized in the period in which the determination is 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. Many of the company's sales arrangements consist of multiple elements, which may include installation services, monthly membership fees, transactions processed, or archive fees. Under Emerging Issues Committee 142, "Revenue Arrangements with Multiple Deliverables", the fee from a multiple element sales arrangement is allocated to each of the individual elements based on each element's relative fair value. The portion of the fee that is allocated to an element is recognized as revenue when all of the criteria for revenue recognition have been met for that element.

Revenue is earned from the provision of the PhotoChannel Network to electronically connect photo-finishing retailers to their customers through the Internet. Revenue received in advance from installation services for the set-up of a customer website is recorded as deferred revenue and is recognized into income over the estimated term of the customer relationship period. Revenue from monthly membership fees from photo-finishing retailers for the connection to the PhotoChannel Network is recognized as the service connection is provided. Revenue from commissions earned on transactions processed by the photo-finishing retailers, utilizing the PhotoChannel Network, is recognized at the time the digital image processing services are provided to the end customer. Revenue from archive fees from online image storage is recognized as the service is provided.

PhotoChannel Networks Inc.

Notes to Consolidated Financial Statements

For the years ended September 30, 2004, 2003 and 2002

(expressed in Canadian dollars)

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

Effective October 1, 2002, the company adopted Canadian Institute of Chartered Accountants (CICA) Handbook Section 3870, "Stock-Based Compensation and Other Stock-Based Payments". The recommendations were applied prospectively to all stock-based compensation to employees and non-employees awarded on or after October 1, 2002.

No compensation expense is recorded for the company's employee stock-based compensation. Consideration paid on the exercise of stock options is recorded as capital stock. A description of the company's stock-based compensation plan and the pro forma effect on the accounting for stock options granted to employees under the fair value method are disclosed in note 6(b).

Stock-based compensation to third parties is recognized and recorded in the accounts of the company at its fair market value determined by the Black-Scholes option pricing model.

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 at their component fair values at the time they were originally issued.

Net loss per share

Basic net earnings (loss) per share are computed using the weighted average number of common shares outstanding during the year. The treasury stock method is used for the calculation of diluted net earnings (loss) per share. Under the treasury stock method, the weighted average number of common shares outstanding for the calculation of diluted net earnings (loss) per share assumes that the proceeds to be received on the exercise of dilutive stock options and warrants are applied to repurchase common shares at the average market price for the period. Stock options and warrants are dilutive when the average market price of the common shares during the period exceeds the exercise price of the options and warrants.

Foreign currency transactions and translation

Monetary assets and liabilities of the company 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 the statement of loss as they arise.

PhotoChannel Networks Inc.

Notes to Consolidated Financial Statements

For the years ended September 30, 2004, 2003 and 2002

(expressed in Canadian dollars)

Use of estimates and measurement uncertainty

The preparation of financial statements in conformity with GAAP 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 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 tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on future tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the date of enactment. A valuation allowance is recognized to the extent the recoverability of future income tax assets is not considered more likely than not.

Comparative amounts

Comparative amounts have been reclassified, where necessary, to conform with the presentation adopted in the current year.

3 Accounts receivable

	2004	2003
	\$	\$
Trade receivables	279,009	96,750
GST receivable	42,140	-
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	321,149	96,750
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PhotoChannel Networks Inc.

Notes to Consolidated Financial Statements

For the years ended September 30, 2004, 2003 and 2002

(expressed in Canadian dollars)

4 Property, plant and equipment

	2004		
	Cost	Accumulated	Net
	\$	amortization	\$
		\$	\$
Computer equipment	3,029,375	2,388,458	640,917
Software	213,649	213,576	73
Furniture and office equipment	152,662	152,451	211
Leasehold improvements	68,206	59,068	9,138
	3,463,892	2,813,553	650,339
	2003		
	Cost	Accumulated	Net
	\$	amortization	\$
		\$	\$
Computer equipment	2,506,915	2,224,685	282,230
Software	208,398	208,398	-
Furniture and office equipment	152,428	152,428	-
Leasehold improvements	59,910	56,567	3,343
	2,927,651	2,642,078	285,573

Amortization of property, plant and equipment for 2004 was \$171,476 (2003 - \$280,778; 2002 - \$890,387).

5 Accounts payable and accrued liabilities

	2004	2003
	\$	\$
Trade payables	309,738	427,972
Trade accruals	60,000	245,003
Accrued payroll taxes	158,668	318,980
Due to employees and consultants	47,438	50,844
Due to former employees	-	74,448
	575,844	1,117,247

PhotoChannel Networks Inc.

Notes to Consolidated Financial Statements

For the years ended September 30, 2004, 2003 and 2002

(expressed in Canadian dollars)

6 Capital stock, stock options, special warrants, warrants and loans receivable

a) Capital stock

Common shares

Authorized

500,000,000 (2003 - 500,000,000; 2002 - 500,000,000) common shares without par value

Issued

176,347,341 (2003 - 127,313,538; 2002 - 77,894,968) common shares without par value

Preferred shares

Authorized

10,000,000 (2003 - 10,000,000; 2002 - 10,000,000) preferred shares without par value

Issued

Nil (2003 - nil; 2002 - nil) preferred shares without par value

Details of the material common stock, stock option and warrant transactions are as follows:

- i) Pursuant to a non-brokered private placement during the year ended September 30, 2004, the company issued 9,600,000 units for net proceeds of \$1,073,751. 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 \$0.15 per share for a period of one year from the date of closing. The net proceeds of \$1,073,751 were allocated: \$794,575 to common shares issued and \$279,176 to the common share purchase warrants. The value allocated to the common share purchase warrants was determined using the Black-Scholes option pricing model with the following weighted average assumptions: dividend yield of \$nil; expected volatility of 100%; risk-free interest rate of 4%; and expected life of one year. The common share purchase warrants expire on July 7, 2005. During the year ended September 30, 2004, none of the common share purchase warrants were exercised.

PhotoChannel Networks Inc.

Notes to Consolidated Financial Statements

For the years ended September 30, 2004, 2003 and 2002

(expressed in Canadian dollars)

- ii) Pursuant to a call option agreement with the limited partners of the PhotoChannel LP, the company exercised its right to acquire all of the Limited Partnership units from the limited partners during the year ended September 30, 2004 (note 7). Under the terms of the call option agreements, the company issued 16,100,000 of its common shares and 13,650,000 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 up to June 30, 2004. The 16,100,000 common shares issued to acquire the Limited Partnership units were attributed a value of \$4,242,000, which was determined by taking the value of the common shares as quoted on the TSX Venture Exchange on the date of issuance. The 13,650,000 common share purchase warrants were attributed a value of \$2,269,063, which was determined using the Black-Scholes option pricing model with the following weighted average assumptions: dividend yield of \$nil; expected volatility of 100%; risk-free interest rate of 4%; expected life of 2.5 months. During the year ended September 30, 2004, 13,150,000 common share purchase warrants were exercised for proceeds of \$1,315,000 and the remaining 500,000 common share purchase warrants expired unexercised.
- iii) Pursuant to a non-brokered private placement during the year ended September 30, 2003, the company issued 5,669,470 units for net proceeds of \$566,947. Each unit consisted of one common share and one common share purchase warrant. 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. The net proceeds of \$566,947 were allocated: \$406,414 to the common shares issued and \$160,533 to the common share purchase warrants. The value allocated to the common share purchase warrants was determined using the Black-Scholes option pricing model with the following weighted average assumptions: dividend yield of \$nil; expected volatility of 100%; risk-free interest rate of 4%; and expected life of one year. During the year ended September 30, 2004, all of the common share purchase warrants were exercised for proceeds of \$566,947.
- iv) Pursuant to a non-brokered private placement during the year ended September 30, 2003, the company issued 25,200,000 common shares at \$0.10 per share. Net proceeds of \$2,425,414 (net of cash issuance costs of \$60,222 and share purchase warrants with a value of \$34,364 (note 6(d)(i))) were recorded as common shares. The company received \$345,000 that had been held in trust at September 30, 2003 related to this private placement. During the year ended September 30, 2004, 174,000 common share purchase warrants were exercised for proceeds of \$24,360.

PhotoChannel Networks Inc.

Notes to Consolidated Financial Statements

For the years ended September 30, 2004, 2003 and 2002

(expressed in Canadian dollars)

- v) 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 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. The net proceeds of \$854,200 were allocated: \$503,953 to the common shares issued and \$350,247 to the common share purchase warrants. The value allocated to the common share purchase warrants was determined using the Black-Scholes option pricing model with the following weighted average assumptions: dividend yield of \$nil; expected volatility of 100%; risk-free interest rate of 4%; and expected life of one year. During the year ended September 30, 2003, 8,292,000 of these common share purchase warrants were exercised for net proceeds of \$829,200. The remaining 250,000 common share purchase warrants expired unexercised on August 6, 2003.
 - vi) 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. During the year ended September 30, 2003, 8,257,100 of these common share purchase warrants were exercised for net proceeds of \$825,710. The remaining 15,633,281 common share purchase warrants expired unexercised on October 17, 2002.
- b) Stock options

During 1997, the company adopted a stock option plan (the Plan). At the company's annual general meeting held on March 10, 2004, the number of common shares reserved under the Plan was increased by 4,400,000 common shares. As at September 30, 2004, the company has reserved 18,000,000 common shares (2003 - 13,600,000; 2002 - 13,600,000) 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 the 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 Plan was amended to include a change in the vesting period, permitting vesting of one-eighteenth of the options granted each month, with the first eighteenth vesting on the date of grant.

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The following table summarizes activity under the company's stock option plan as of September 30, 2002, 2003 and 2004:

Stock options	Number of options	Weighted average exercise price of outstanding options \$	Weighted average exercise price of exercisable options \$
Outstanding - September 30, 2001 (5,050,397 shares exercisable)	9,520,189	0.66	0.83
Granted	6,299,611	0.15	
Expired	(15,000)	1.47	
Forfeited	(2,465,480)	1.20	
Outstanding - September 30, 2002 (7,023,490 shares exercisable)	13,339,320	0.15	0.19
Granted	1,050,000	0.16	
Expired	(175,000)	0.15	
Forfeited	(1,149,320)	0.15	
Outstanding - September 30, 2003 (11,692,818 shares exercisable)	13,065,000	0.17	0.17
Granted	3,775,000	0.31	
Exercised	(1,080,333)	0.15	
Outstanding - September 30, 2004 (12,893,001 shares exercisable)	15,759,667	0.20	0.18

The following table summarizes information about stock options outstanding and exercisable at September 30, 2004:

Exercise price \$	Options outstanding			Options exercisable		
	Number outstanding	Weighted average remaining contractual life (years)	Weighted average exercise price \$	Number exercisable	Weighted average exercise price \$	
0.15	11,034,667	2.2	0.15	10,934,667	0.15	
0.17	750,000	4.0	0.17	500,000	0.17	
0.30	500,000	4.4	0.30	166,667	0.30	
0.31	3,275,000	4.2	0.31	1,091,667	0.31	
US1.00	200,000	0.8	US1.00	200,000	US1.00	
0.15 - US1.00	15,759,667	2.0	0.20	12,893,001	0.18	

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During the year ended September 30, 2004, no stock options were provided to consultants for services rendered. During the year ended September 30, 2003, the company expensed \$97,181 (2002 - \$73,343) in stock-based compensation related to services provided by consultants, who were granted 750,000 stock options (2002 - 1,033,000).

Stock-based compensation expense arising from grants of options to non-employees is estimated using the Black-Scholes option pricing model assuming no dividend yield and the following weighted average assumptions for options granted:

	2004	2003	2002
Expected volatility	N/A	100%	100%
Risk-free interest rate	N/A	4%	4%
Expected life (in years)	N/A	5	5

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 \$0.50 to \$1.57 per option to \$0.15 per option.

Under the company's current accounting policy, the company has not recognized any compensation expense for stock options issued to employees during the year. Had the company determined the expense of granting stock options to employees during the year, based on the fair value method, the effect of pro forma compensation expense on the company's loss and loss per share would be as follows:

	2004	2003
	\$	\$
Loss attributed to common shareholders	3,052,485	2,449,984
Additional compensation expense	314,011	-
Pro forma loss	<u>3,366,496</u>	<u>2,449,984</u>
Pro forma - basic and diluted loss per share	<u>0.02</u>	<u>0.03</u>

The fair value of each stock option is estimated on the date of grant using the Black-Scholes option pricing model with the following assumptions being used in both 2004 and 2003: dividend yield of \$nil; expected volatility of 100%; risk-free interest rate of 4%; and expected life of five years.

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c) Special warrants

On October 17, 2001, the company received conditional approval from 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 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 24,890,381 common share purchase warrants were issued.

d) Warrants

- i) During the year ended September 30, 2003, the company retained First Associates Investments Inc. (First Associates) to assist in raising funds for the company. On September 16, 2003 and pursuant to the private placement of 25,200,000 common shares of the company, the TSX Venture Exchange approved the issuance of 500,000 common share purchase warrants, with immediate vesting, for services provided. The common share purchase warrants are exercisable on or before October 7, 2005, at a price of \$0.14. The common share purchase warrants were assigned a value of \$34,364, which has been included as a share issue cost and recorded in equity. The value was determined using the Black-Scholes option pricing model with the following weighted average assumptions: dividend yield of \$nil; expected volatility of 100%; risk-free interest rate of 4%; and expected life of 1.25 years. During the year ended September 30, 2004, 174,000 common share purchase warrants were exercised for proceeds of \$24,360.
- ii) During the year ended September 30, 2002, the company retained TELUS Communications Inc. (TELUS) to provide consulting services to the company, under an agreement dated June 4, 2002. As consideration, the company had agreed to issue TELUS up to 7,600,000 common share purchase warrants, which were to be provided as earned during and under the terms of the agreement. On February 27, 2003, the TSX Venture Exchange, TELUS and the company agreed to the issuance of 2,100,000 common share purchase warrants, with immediate vesting, in lieu of fees of \$105,000 for services provided to January 4, 2003. The common share purchase warrants were issued on February 27, 2003 and are exercisable on or before February 27, 2005, at a price of \$0.10. These common share purchase warrants were assigned the value of \$105,000, which has been included as a general and administrative expense and recorded in equity. During the year ended September 30, 2004, none of these common share purchase warrants were exercised.

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- iii) During the year ended September 30, 2002, the company retained NBJ Enterprises Ltd., dba Skana Photo-Lab Products (Skana), to act as a distributor for the company's products in Canada, under an agreement dated February 1, 2002. Amongst other consideration, the company had agreed to issue Skana up to 2,000,000 common share purchase warrants, which were to be provided as earned during and under the terms of the agreement. On January 22, 2003, the TSX Venture Exchange approved the issuance of 2,000,000 common share purchase warrants, with immediate vesting, for services provided. The common share purchase warrants were issued on January 22, 2003 and are exercisable on or before January 22, 2005, at a price of \$0.10. The common share purchase warrants were assigned a value of \$93,000, which has been included as a sales and marketing expense and recorded in equity. The value was determined using the Black-Scholes option pricing model with the following weighted average assumptions: dividend yield of \$nil; expected volatility of 100%; risk-free interest rate of 4%; and expected life of two years. During the year ended September 30, 2004, 235,000 common share purchase warrants were exercised for proceeds of \$23,500.
- iv) 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. As consideration, the company issued 5,000,000 common share purchase warrants to Discovery. On July 26, 2002, the TSX Venture Exchange approved the issuance of 4,325,000 common share purchase warrants, with immediate vesting, as full consideration under the agreement. The common share purchase warrants were issued on July 26, 2002 and were exercisable on or before July 26, 2004, at a price of \$0.10. Also during fiscal 2002, the company issued Discovery a finder's fee of 700,000 common share purchase warrants (Finder's Warrants), on the private placement of units of the PhotoChannel LP. The Finder's Warrants were 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 with the following weighted average assumptions: dividend yield of \$nil; expected volatility of 100%; risk-free interest rate of 4%; and expected life of two years. During the year ended September 30, 2004, the company issued 3,025,000 common shares of the company for proceeds of \$302,500 upon exercise of the common share purchase warrants (2003 - 2,000,000 for proceeds of \$200,000).
- v) On May 11, 2000, the company granted 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 common share purchase warrant was assigned a value of \$1,700,000, which was recorded in equity. The value of the common share purchase warrant was determined using the Black-Scholes option pricing model with the following assumptions: expected dividend yield of \$nil; an expected volatility of 146%; risk-free interest rate of 6.17%; and expected life of five years. At September 30, 2004, this share purchase warrant remains outstanding.

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e) Loans receivable

During the year ended September 30, 2002, the company made loans totalling \$227,470 to employees, which were secured by common shares of the company. As at September 30, 2004, loans totalling \$17,600 (2003 - \$122,206) were outstanding and have been recorded as a charge to shareholders' equity. The loans are non-interest bearing and are repayable on demand. The common shares held as collateral have a market value at September 30, 2004 of \$29,920.

7 Limited Partnership equity

On February 14, 2002, 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 initially sold 1,250 Limited Partnership units in June 2002, at a price of \$1,000 per unit, raising \$1,250,000. In December 2002 and September 2003, the partnership sold an additional 115 units and 245 units, respectively, at a price of \$1,000 per unit, raising \$360,000. The company had granted to the PhotoChannel LP a software license to commercially exploit the PhotoChannel Network in Canada. Pursuant to an operating agreement, the company received payments for services provided to the PhotoChannel LP from the software license agreement and management and operating services agreements (representing software rights, management, personnel and facilities and equipment that the company had agreed to provide to the PhotoChannel LP), which enabled the company to continue its development, deployment and exploitation of its digital imaging network software in other market segments.

A condition of the PhotoChannel LP agreement was that each limited partner enter into an agreement with the company, pursuant to which the company had a call option to acquire all, but not less than all, of the Limited Partnership units from the limited partners, at any time on or before June 30, 2004. Under the call option, each of the Limited Partnership units sold in June and December 2002 would be exchanged for 10,000 units of the company, with each unit comprising of one common share and one common share purchase warrant. 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, at any time on or before the earlier of two years from the date of issue of the Limited Partnership units and June 30, 2004. Each Limited Partnership unit sold in September 2003 could be exchanged for 10,000 common shares of the company.

Given the existence of the company's option to acquire the Limited Partnership units from the limited partners, certain common ownership and management of the company and the Limited Partnership, and the company's effective control over the PhotoChannel LP, the partnership equity was presented as a separate class of equity within shareholders' equity of the company. The accounts of the partnership were consolidated with those of the company since the inception of the PhotoChannel LP.

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The company also entered into a support agreement, pursuant to which the company agreed to provide financing to the Limited Partnership, in connection with operational and capital costs, once substantially all equity generated from the Limited Partnership units was utilized. Losses incurred by the Limited Partnership in 2002 and 2003 were allocated first to the Limited Partnership units to the extent of their equity investment and thereafter to the company. In 2002, the company had previously attributed all losses to the company. Accordingly, the loss for 2002 has been restated for comparative purposes to allocate losses to the Limited Partnership units to the extent of the equity.

This restatement had the effect of reducing the deficit attributable to the company's common shareholders from \$38,963,665 to \$37,726,075, the net loss attributed to common shareholders from \$1,851,661 to \$614,071 and the basic and fully diluted net loss per share from \$0.03 to \$0.01.

In April, 2004, the company exercised its call options with the limited partners thereby acquiring all of the Limited Partnership units. Under the terms of the call option agreements the company issued 16,100,000 common shares and 13,650,000 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 up to June 30, 2004. The company recorded the redemption of the PhotoChannel LP at the fair value of the common shares and common share purchase warrants (note 6(a)(ii)), with the offsetting amount recorded as an increase in its deficit.

8 Net change in non-cash working capital items

	2004	2003	2002
	\$	\$	\$
Accounts receivable	(224,399)	20,935	(29,681)
Prepaid expenses	1,125	15,603	(8,200)
Accounts payable and accrued liabilities	(541,403)	(1,464,214)	(2,603,809)
Deferred revenue	115,769	60,000	-
Due to related parties	-	(273,612)	273,612
	<u>(648,908)</u>	<u>(1,641,288)</u>	<u>(2,368,078)</u>

PhotoChannel Networks Inc.

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9 Revenue

The following is a breakdown of the company's revenue for the years ended September 30, 2004, 2003 and 2002:

	2004	2003	2002
	\$	\$	\$
Transaction commission fees	361,350	90,054	3,588
Installation fees	187,940	86,914	57,387
Membership fees	96,519	73,120	104,410
Other	60,240	2,541	8,416
Archive fees	57,091	2,944	-
	<u>763,140</u>	<u>255,573</u>	<u>173,801</u>

10 Expense details

	2004	2003	2002
	\$	\$	\$
Network delivery			
Telecommunication costs	128,873	71,570	72,078
Salaries and customer service	100,810	20,600	46,140
Laboratory system installation	52,288	9,781	5,877
Other	45,218	9,740	33,715
	<u>327,189</u>	<u>111,691</u>	<u>157,810</u>
General and administration			
Salaries and consulting	754,439	1,031,291	2,099,424
Office and miscellaneous	287,797	203,024	502,308
Interest and penalties	78,157	113,719	129,188
Accounting and legal	123,932	106,498	337,569
Investor relations	90,000	29,900	16,000
Rent	68,994	92,927	106,661
Bad debt	18,100	-	-
Loss on sale of property, plant and equipment	-	44,209	386
	<u>1,421,419</u>	<u>1,621,568</u>	<u>3,191,536</u>
Sales and marketing			
Salaries and consulting	549,797	678,876	602,432
Printing, advertising and promotion	49,284	1,574	1,372
Miscellaneous	42,925	54,342	50,452
	<u>642,006</u>	<u>734,792</u>	<u>654,256</u>

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	2004 \$	2003 \$	2002 \$
Research and development			
Salaries and consulting	1,219,808	766,890	611,223
Miscellaneous	59,430	22,299	3,261
	<u>1,279,238</u>	<u>789,189</u>	<u>614,484</u>

Gain on settlement of obligations

During the year ended September 30, 2003, the company recognized a gain on settlement of obligations of \$457,599 (2002 - \$808,774) as a result of debt settlements with various trade creditors and past employees of the company.

Gain on bankruptcy of subsidiary

On November 1, 2001, PhotoChannel, Inc., the company's U.S. 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 U.S. 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.

11 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 \$17,923,000, which are available for carry forward to reduce future years' taxable income. These income tax losses expire as follows:

	\$
Year ending September 30	
2005	2,721,000
2006	2,065,000
2007	5,391,000
2008	2,630,000
2009	-
2010	2,119,000
2011	2,997,000
	<u>17,923,000</u>

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The tax effect of temporary differences that give rise to significant portions of future income tax assets and future income tax liabilities is as follows:

	2004 \$	2003 \$	2002 \$
Net operating loss carry-forwards	6,384,000	6,455,911	5,883,656
Property, plant and equipment	1,896,000	1,803,587	1,705,314
Share issue costs	159,000	72,840	69,533
	8,439,000	8,332,338	7,658,503
Valuation allowance	(8,439,000)	(8,332,338)	(7,658,503)
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, 2004 differs from the amount obtained by applying the applicable statutory income tax rates to loss before income taxes as follows:

	2004	2003	2002
Combined statutory income tax rate	36%	38%	42%
	\$	\$	\$
Income tax recovery based on combined statutory rate	1,098,895	930,994	257,910
Expiration of tax losses	(1,232,140)	(169,467)	-
Effect of change in tax rates	(30,525)	(73,500)	(42,985)
Non-deductible expenses and other differences	270,432	(14,193)	(14,972)
Change in valuation allowance	(106,662)	(673,834)	5,029,582
Effect of U.S. subsidiary Chapter 7 bankruptcy	-	-	(5,229,535)
	-	-	-

12 Related party transactions

During the year ended September 30, 2004, the company incurred consulting fees to companies controlled by directors and officers of the company of approximately \$179,167 (2003 - \$134,658; 2002 - \$360,833). The fees were recorded in general and administration expense.

All amounts owing to these related parties had been paid by September 30, 2004 and 2003, respectively.

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13 Segmented information

The company's only reportable segment is the provision of digital image delivery, hosting, storage and financial reporting for photo-finishing retailers.

The company's sales by geographical area are as follows:

	2004 \$	2003 \$	2002 \$
Canada	567,211	145,559	-
United States	187,850	110,014	173,801
Other	8,079	-	-
	<u>763,140</u>	<u>255,573</u>	<u>173,801</u>

Revenue is attributable to the geographic location of the company's customer. At September 30, 2004 and 2003, all of the company's property, plant and equipment were located in Canada.

Major customers, representing 10% or more of sales, include:

	2004 \$	2003 \$
Customer A	177,523	-
Customer B	108,983	27,400
Customer C	89,318	28,905
Customer D	76,063	-
Customer E	-	39,682
Customer F	-	36,444

During the year ended September 30, 2002, no individual customers made up more than 10% of sales.

14 Financial instruments

a) Fair values

The fair values of cash and cash equivalents, cash held in trust, accounts receivable, and accounts payable and accrued liabilities approximate their carrying amounts due to the near-term maturity of these instruments.

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b) Credit risk

Financial instruments that potentially subject the company to significant concentrations of credit risk consist primarily of cash and cash equivalents, cash held in trust and accounts receivable. The company limits its exposure to credit risk by placing its cash and cash equivalents and cash held in trust with high credit quality financial institutions and corporations. The company does not have a significant exposure to any individual customer or counter party. The company provides 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.

15 Commitments and contingencies

Commitments

The company has entered into agreements to lease premises and services for periods to 2007. The annual rent for premises includes minimum rent plus realty taxes and operating expenses. Minimum payments for each of the next three years are as follows:

	\$
2005	413,726
2006	394,056
2007	<u>216,775</u>
	<u>1,024,557</u>

Contingencies

The company is involved in claims litigation arising in the ordinary course of business. In the opinion of management, the outcome of such claims litigation, if decided adversely, could have an effect on the operating results or cash flows when resolved in a future period. However, in the opinion of management, these matters will not materially affect the company's consolidated financial position.

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16 Recent Canadian accounting pronouncements

a) Consolidation of variable interest entities

In June 2003, the CICA issued Accounting Guideline 15, "Consolidation of Variable Interest Entities", which will be effective for annual and interim periods beginning on or after November 1, 2004. This guideline addresses the application of consolidation principles to entities that are subject to control on a basis other than ownership of voting interests. The company does not expect the adoption of this section to have a significant impact on its consolidated financial statements.

b) Stock-based compensation

In September 2003, the CICA released amendments to the transitional provisions of Section 3870, which requires the adoption of the fair value based method of accounting for stock-based compensation. Section 3870 requires an expense to be recognized in financial statements for all forms of employee stock-based compensation, including stock options, effective for periods beginning on or after January 1, 2004, for public enterprises. The company is currently assessing the impact of adopting this section on its financial results for the year ending September 30, 2005.

