

NOTICE THAT FINANCIAL STATEMENTS HAVE NOT BEEN REVIEWED BY AN AUDITOR

PhotoChannel Networks Inc.
Interim Financial Statements for the period ended December 31, 2005

The Issuer's auditors have not reviewed or been involved in the preparation of these financial statements.

PhotoChannel Networks Inc.

Consolidated Balance Sheets

Unaudited – Prepared by Management

(expressed in Canadian dollars)

	<u>December 31, 2005</u>	<u>September 30, 2005</u>
Assets		
Current assets		
Cash and cash equivalents	\$ 560,073	\$ 187,318
Accounts receivable	951,562	417,766
Inventory	50,639	70,971
Prepaid expenses	116,549	62,122
	<u>1,678,823</u>	<u>738,177</u>
Capital assets	<u>1,061,652</u>	<u>870,075</u>
	<u>\$ 2,740,475</u>	<u>\$ 1,608,252</u>
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities	\$ 1,032,896	\$ 1,138,203
Deferred and unearned revenue	507,936	188,040
	<u>\$ 1,540,832</u>	<u>\$ 1,326,243</u>
Shareholders' Deficiency		
Capital stock	\$ 44,997,289	\$ 43,625,343
Contributed surplus	9,320,285	9,303,378
Warrants	843,020	698,873
Deficit	<u>(53,960,951)</u>	<u>(53,345,585)</u>
	<u>1,199,643</u>	<u>282,009</u>
	<u>\$ 2,740,475</u>	<u>\$ 1,608,252</u>

Approved by the Board of Directors

"Peter Fitzgerald" Director "Cory Kent" Director

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

PhotoChannel Networks Inc.
Consolidated Statements of Loss and Deficit
Unaudited – Prepared by Management
(expressed in Canadian dollars)

	Three Months Ended	
	December 31, 2005	December 31, 2004
Revenue	\$ 542,714	\$ 440,614
Expenses		
General and administration	322,382	351,253
Sales and marketing	155,507	112,660
Network delivery	205,082	121,543
Research and development	395,659	280,519
Amortization	77,088	52,509
	<u>1,155,718</u>	<u>918,484</u>
Net loss from operations	(613,004)	(477,870)
Other Income (loss)		
Translation gain (loss)	(3,515)	(2,416)
Interest and miscellaneous income	1,153	3,508
	<u>(2,362)</u>	<u>1,092</u>
Net loss for the period	(615,366)	(476,778)
Deficit - beginning of period	(53,345,585)	(49,739,607)
Deficit - end of period	<u>\$ (53,960,951)</u>	<u>\$ (50,216,385)</u>
(Loss) Gain per share attributable to common shareholders	<u>\$ (0.00)</u>	<u>\$ (0.00)</u>
Weighted average number of common shares outstanding	<u>187,647,649</u>	<u>160,472,028</u>

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

PhotoChannel Networks Inc.

Consolidated Statements of Cash Flows

Unaudited – Prepared by Management

(expressed in Canadian dollars)

	Three Months Ended	
	December 31, 2005	December 31, 2004
Cash flows from operating activities		
Net (loss) gain for the period	\$ (615,366)	\$ (476,778)
Items not affecting cash		
Amortization	77,088	52,509
	(538,278)	(424,269)
Net change in non-cash working capital items	(353,302)	68,599
	(891,580)	(355,670)
Cash flows from investing activities		
(Purchase) Disposal of property, plant and equipment	(268,665)	(38,071)
	(268,665)	(38,071)
Cash flows from financing activities		
Issuance of common shares and warrants – net proceeds	1,533,000	-
Issuance of common shares on exercise of warrants and options	-	49,950
	1,533,000	49,950
Increase (decrease) in cash and cash equivalents	372,755	(343,791)
Cash and cash equivalents - beginning of period	187,318	955,965
Cash and cash equivalents - end of period	\$ 560,073	\$ 612,174

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

PhotoChannel Networks Inc.

Notes to Consolidated Financial Statements

Unaudited – Prepared by Management

(expressed in Canadian dollars)

1. Summary of significant accounting policies

General

These unaudited interim consolidated financial statements have been prepared in accordance with generally accepted accounting principles (GAAP) in Canada, using the same accounting policies as outlined in Note 2 to the most recent audited consolidated financial statements for the year ended September 30, 2005. These unaudited interim consolidated financial statements do not include all disclosures required for annual financial statements and should be read in conjunction with the audited consolidated financial statements for the year ended September 30, 2005. Certain comparative figures in the unaudited interim consolidated financial statements have been reclassified to conform to the current period presentation.

In the opinion of management, all adjustments (which include reclassifications and normal recurring adjustments) necessary to present fairly the consolidated financial position, consolidated earnings, and consolidated cash flows as at December 31, 2005 and for all periods presented, have been made. The earnings for the three months ended December 31, 2005 are not necessarily indicative of the earnings for the full year ending September 30, 2006. All amounts herein are expressed in Canadian dollars unless otherwise noted.

All material inter-company balances and transactions are eliminated upon consolidation.

Nature of operations and going concern

The company has 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. While these unaudited interim 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 2006 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.

PhotoChannel Networks Inc.

Notes to Consolidated Financial Statements

Unaudited – Prepared by Management

(expressed in Canadian dollars)

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.

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(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

In November 2001, the Canadian Institute of Chartered Accountants issued Handbook Section 3870, “Stock-Based Compensation and other Stock-Based Payments”. Section 3870 sets out a fair value based method for the recognition, measurement and disclosure of certain stock-based compensation and other stock-based payments made in exchange for goods and services. The standard requires the use of the fair value based method for direct awards of stock, stock appreciation rights and awards that call for settlement in cash or other assets. Awards that a company has the ability to settle in stock are recorded as equity, whereas awards that the company is required to or has a practice of settling in cash are recorded as liabilities. This section applies to certain awards outstanding on the date of adoption, being October 1, 2004 for the company, and relates to all awards granted on or after October 1, 2002. As a result, the company applied the recommendations with retroactive application and recorded an adjustment to opening deficit of \$314,011 in the fiscal year ending September 30, 2005. Previously, the company disclosed the pro forma effect of employee stock-based compensation expense in the notes to the financial statements.

When stock options are granted to non-employees, compensation expense is recognized, based on the fair value of the stock options granted. The expense is recorded based on the fair value at the earliest of the date at which the counterparty’s performance is complete, a commitment for performance by the counterparty to earn the stock options is reached, or the stock options are granted, if they are fully vested and non-forfeitable at that date.

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.

PhotoChannel Networks Inc.

Notes to Consolidated Financial Statements

Unaudited – Prepared by Management

(expressed in Canadian dollars)

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.

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, when necessary, to conform to the presentation adopted in the current year.

2. Accounts receivable

	<u>As at December 31, 2005</u>		<u>As at September 30, 2005</u>
Trade accounts receivable	\$ 951,562	\$	394,095
GST receivable	-		23,671
Total	<u>\$ 951,562</u>	<u>\$</u>	<u>417,766</u>

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(expressed in Canadian dollars)

3. Capital stock, stock options and loans receivable

a) Capital stock

Issued	As at December 31, 2005		As at September 30, 2005	
Common shares		220,514,841		203,514,841
Amount	\$	44,997,289	\$	43,625,343

b) Options

The Company has a stock option plan that grants to directors and certain employees of the Company the option to purchase up to 18,000,000 common shares of the Company. The exercise price of each option is determined by the market price of the Company's stock on the date of the grant and an option's maximum term is five years. Options generally vest over 18 months. During the three months ended December 31, 2005, nil options (2004 – 11,025,000) were granted to employees.

The board of directors is proposing that shareholders adopt a new share option plan (the "New Plan") at its annual general meeting of shareholders to be held on March 6, 2006. The New Plan will use a "rolling" number of shares rather than a "fixed" number of shares. The board of directors have recommended that under the New Plan, a maximum of 10% of the issued and outstanding common shares of the Company at the time an option is granted, less any outstanding option, will be reserved for issuance as options to be granted at the discretion of the Company's board of directors. Initially, if adopted, 22,051,484 common shares will be the maximum number of options to be granted under the New Plan, versus 18,000,000 common shares under the present plan.

4. Business segment information

The Company 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:

Revenue	Canada		US		Other	
For the three months ended December 31, 2005	\$	514,499	\$	27,841	\$	374
For the three months ended December 31, 2004	\$	291,265	\$	147,460	\$	1,889

Revenue is attributable to the geographic location of the Company's customer. As at December 31, 2005 and 2004, all of the Company's property, plant and equipment were located in Canada.

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Unaudited – Prepared by Management
(expressed in Canadian dollars)

5. Revenue

Description	Three Months December 31, 2005	Twelve Months September 30, 2005
Installation fees	\$ 79,017	\$ 676,274
Membership fees	158,655	519,037
Transaction fees	233,733	708,438
Archive fees	30,056	107,515
Other	41,253	105,239
Total	\$ 542,714	\$ 2,116,503

6. Expense details

	December 31, 2005
General and administration	
Accounting and legal	\$ 8,710
Investor relations	15,000
Office and miscellaneous	48,031
Public company fees	7,001
Salaries	116,361
Consulting	105,419
Interest	1,608
Rent	20,252
	\$ 322,382
Sales and marketing	
Salaries	\$ 48,501
Consulting	55,730
Printing, advertising and promotion	41,931
Travel and Miscellaneous	9,345
	\$ 155,507
Network Delivery	
Telecommunication costs	\$ 51,678
Customer Service	69,469
Lab system installation	38,104
Other	45,831
	\$ 205,082
Research and development	
Salaries	\$ 205,737
Consulting	175,305
Miscellaneous	14,617
	\$ 395,659