



**PHOTOCHANNEL**

**MANAGEMENT DISCUSSION & ANALYSIS**

**January 30, 2006**

This discussion and analysis of PhotoChannel Networks Inc. ("PhotoChannel" or the "Company") should be read in conjunction with the consolidated financial statements and accompanying notes. The financial information reported herein has been prepared in accordance with Canadian Generally Accepted Accounting Principles ("GAAP") and is presented in Canadian dollars, unless otherwise noted.

This discussion and analysis may contain forward-looking statements involving risks and uncertainties including, but not limited to, changes in the market and changes in the economy. Such statements reflect the Company's views at January 30, 2006 with respect to future events and are subject to certain risks, uncertainties and assumptions.

### **Business Overview**

PhotoChannel has created and manages the open standard PhotoChannel Network environment. The PhotoChannel system is currently utilized by major photofinishing retailers and wireless carriers to provide their consumers with online image printing and picture messaging services. There are more than 8,000 retail locations worldwide now fulfilling print and gifting items from digital images received through the PhotoChannel system. For more information on the Company visit [www.photochannel.com](http://www.photochannel.com).

The Company provides its photofinishing retailers with a customer branded online solution, which allows consumers the ability to easily upload and order prints and gifting items from their digital images and pick up these products at the selected retailer location.

The Company provides customers of its wireless carriers with the ability to, not only, order prints and gifting items from their digital images, but to also take advantage of picture messaging capabilities from their camera cell phones.

All of these services are provided from PhotoChannel's partner hosting facility located at TELUS Communications Inc.'s co-location facility in Burnaby, BC. The Company's infrastructure and model permits managed growth while keeping authority and

responsibility with its operational teams that deliver the services.

Our strategy for growth is to:

- Contract or partner with established retail chains in the photofinishing industry;
- Contract or partner with wireless carriers who are interested in providing consumers with a full camera cell phone solution;
- Maintain service and product excellence for strong customer retention and development;
- Maintain a close relationship with our customers by providing marketing solutions that encourage new users to the online solution; and
- Provide a workplace conducive to attracting and retaining talented people.

### **FISCAL 2005 OVERVIEW**

In fiscal 2005, the Company worked with its Canadian retailers to expand their consumer's acceptance and usage of the online solution. This resulted in significant growth in the Company's transaction commission fees.

During this period certain of the Company's existing retailers commenced deployment of PhotoChannel's lab servers. Once deployed these lab servers enable the retailer to print in-store, thereby offering consumers the equivalent of one hour photofinishing from digital images.

Also during fiscal 2005 and subsequent to the employment of the Company's new Chief Technology Officer in November 2004, the Company began and completed architecting and building a new infrastructure platform. Black Photo Corporation was the Company's first customer to be rolled out onto this new platform in September 2005. The Company is now in the process of completing the rollout of existing and new customers onto this platform. It is the Company's belief that this new platform is state-of-the-art and will allow it to compete more efficiently and effectively in the photofinishing marketplace.

## **MARKET SEGMENTATION**

The Company's only reportable segment is the provision of digital image delivery, hosting, storage and financial reporting for photofinishing retailers and wireless carriers.

## **GEOGRAPHIC**

The Company's sales have been primarily in Canada and the United States. During fiscal 2005, the Company reported that 83% of its revenue was generated in Canada and 17% from within the United States. Revenue from Canada and the United States increased in fiscal 2005 by 209% and 92.5%, respectively.

## **OPERATIONAL CAPABILITY**

PhotoChannel's primary operational capability is through its employees and infrastructure. We believe it is essential to employ experienced and capably trained personnel to meet our customer's continually increasing expectations for the "best" solution, as space for online delivery of digital images evolves. In fiscal 2005, the Company re-architected and built a new infrastructure from the ground up, which offers greater upload speed, ease and usability, along with scalability. The Company believes that this new infrastructure is state-of-the-art and will assist it in securing new contracts with the industry's largest photofinishing retailers. Our new infrastructure is built around industry standard solutions (Sequel Server database, asp.net, C# and a Storage SAN solution). This new platform is now being rolled out to existing and new customers. We believe our new infrastructure will allow us to grow in the future.

In fiscal 2005, the Company increased its development staffing by three. The Company presently has 17 development staff.

In November 2004, the Company retained the services of an industry veteran to act as Chief Technology Officer for us. This individual's primary responsibility will be to ensure that the Company has a solution in place to meet our expected growth and the industry's evolving technological advancements.

The Company continues to also contract with technology consultants, when necessary, to extend its operational capacity. These

consultants augment our resource pool with specialists, as needed, without the liability of longer-term commitment.

## **RESULTS OF OPERATIONS**

Fiscal 2005 was an exciting year for PhotoChannel. Overall revenues increased 177% from 2004. The increase was primarily due to an increase in transaction commission fees, installation fees and membership fees of 96%, 260% and 438%, respectively. The increase in transaction commission fees was due to the continued acceptance of consumers of the online solution as a very viable alternative to walking in-store with their digital media. The increase in installation fees was a result of retailers commencing to install PhotoChannel lab servers in their retail locations. These installations resulted in an increase in membership fees, which are charged to the retailer for their ability to print directly in-store, offering consumers the equivalent of one hour photofinishing from digital images.

Expenses increased by 38% from 2004, primarily due to an increase in network delivery, general and administrative and research and development costs of 174%, 27% and 26%, respectively.

Network delivery costs increased primarily due to an increase in the number of transactions processed and the installation cost of lab servers associated with the retailer offering in-store printing of photographs. The increase in the number of transactions resulted in an increase in the Company's usage of bandwidth (i.e. internet related costs), along with an increase in salaries related to customer service staff required. The increase in the number laboratory system installations is related to the interest of certain retailers in offering an in-store, one hour online photofinishing solution to consumers.

General and administrative costs increased primarily due to an increase in staffing and consultants and a one time charge for severance in the amount of \$178,027, along with a charge of \$124,338 for stock-based compensation expense.

Research and development costs increased primarily due to an increase in staffing, as the Company architected and built the new platform, while maintaining its existing platform. In fiscal 2005, the Company hired additional developers,

a database administrator and used certain consulting specialists to help it complete and launch its new infrastructure, while maintaining its existing customers needs on its old infrastructure.

Sales and marketing costs increased from 2004 by 5% as a result of an increase in salaries and consulting. As 80% of all photofinishing is done by 20% of the retailers, the Company is focused on the larger retailers allowing it to maintain a relatively small sales staff, as it expands.

Amortization expense increased by 77%, as the Company purchased new hardware and software for the development and deployment of its new infrastructure. The amortization policy of the capital assets is described in note 2 of the financial statements.

Operating loss for fiscal 2005 increased by 3% due to the increase in operating expenses, which were primarily offset by the increase in revenues.

#### **LIMITED PARTNERSHIP ACQUISITION**

As stated in note 7 to the financial statements, the Company exercised its call options with the limited partners of the PhotoChannel LP in April 2004. This resulted in the Company reacquiring all of its rights under contracts entered into by the PhotoChannel LP with Canadian retailers. The Company recorded the redemption of the PhotoChannel LP at the fair value of the common shares and common share purchase warrants, as per note 6 (a) (iv) of the financial statements, with the offsetting amount recorded as an increase in its deficit.

#### **TAXATION AND OTHER NON- OPERATING ITEMS**

Since inception PhotoChannel has sustained significant tax losses and continues to strive to generate sufficient revenues to cover its operating costs in an industry characterized by rapid technological change. In fiscal 2005, given sufficient uncertainty regarding the realization of future income tax assets, and in line with its current accounting practices, PhotoChannel determined that was appropriate to take a full valuation allowance against the future income tax assets. Therefore, a non-cash valuation

allowance of \$8,560,000 was recorded in 2005, as per note 11 of the financial statements.

#### **CONDENSED FINANCIAL INFORMATION**

The following table provides selected financial information (prepared in accordance with Canadian GAAP) for the years indicated. This selected information should be read together with the consolidated financial statements, including the related notes, contained in the Company's audited consolidated financial statements for the years ended September 30, 2005, 2004 and 2003.

## CONDENSED FINANCIAL INFORMATION

### Statement of Operations

For the year ended September 30,

	2005	2004	2003
Revenue	\$ 2,116,503	\$ 763,140	\$ 255,573
Net loss	3,147,967	3,052,485	2,822,394
<b>Net loss attributable to common shareholders</b>	<b>\$ 3,147,967</b>	<b>\$ 3,052,485</b>	<b>\$ 2,449,984</b>
Basic and diluted loss per share	\$ 0.02	\$ 0.02	\$ 0.03
Cash and cash equivalents	\$ 187,318	\$ 955,965	\$ 1,104,410
Total current assets	738,177	1,295,353	1,565,524
Total assets	1,608,252	1,945,692	1,851,097
Total current liabilities	1,326,243	751,613	1,177,247
Total liabilities	1,326,243	751,613	1,177,247
Shareholders' (deficiency) equity	282,009	1,194,079	673,850
Shareholder's equity - Beginning of year	\$ 1,194,079	\$ 673,850	\$ (2,145,836)
Net earnings attributable to common shareholders	(3,147,967)	(3,052,485)	(2,449,984)
Redemption of Limited Partnership units	-	(6,511,063)	-
Issue of equity capital	2,676,308	9,979,171	5,176,816
Limited partnership equity	-	-	(12,410)
Modification of existing warrants	(144,000)	-	-
Compensation expense for existing options	(314,011)	-	-
Repayment of loans receivable	17,600	104,606	105,264
<b>Shareholder's equity - End of year</b>	<b>\$ 282,009</b>	<b>\$ 1,194,079</b>	<b>\$ 673,850</b>

## OUTSTANDING SHARE INFORMATION AS AT JANUARY 30, 2005

### Authorized

Common shares	unlimited
Preferred shares	unlimited

### Issued and outstanding

Common shares	220,514,841
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### Options Outstanding

15,356,771

## CONDENSED QUARTERLY FINANCIAL INFORMATION

The following table provides selected quarterly information for PhotoChannel's eight most recent quarters. This information is unaudited, but reflects all adjustments of a normal, recurring nature which are, in the opinion of management, necessary to present a fair statement of PhotoChannel's results of operations for the periods presented. Quarter-to-quarter comparisons of PhotoChannel's financial results are not necessarily meaningful and should not be relied upon as an indicator of future performance.

	Dec. 31, 2003	Mar. 31, 2004	Jun. 30, 2004	Sept. 30, 2004
Revenue	\$ 181,372	\$ 231,495	\$ 208,766	\$ 141,507
Net loss	696,283	519,437	575,563	1,261,202
Net loss attributable to common shareholders	696,283	519,437	575,563	1,261,202
Basic and diluted net loss per share	\$ 0.01	\$ 0.01	\$ -	\$ 0.01

  

	Dec. 31, 2004	Mar. 31, 2005	Jun. 30, 2005	Sept. 30, 2005
Revenue	\$ 440,614	\$ 554,742	\$ 564,775	\$ 556,372
Net loss	477,870	751,213	892,617	1,026,267
Net loss attributable to common shareholders	477,870	751,213	892,617	1,026,267
Basic and diluted net loss per share	\$ -	\$ -	\$ 0.01	\$ 0.01

### FOURTH QUARTER RESULTS

Fourth quarter revenue during fiscal 2005 increased by 293% or \$414,865 over the corresponding period of fiscal 2004. This increase was primarily due to an increase in transaction commission fees of 135% and membership fees of 338% from 2004.

Fourth quarter operating costs increased by 38% from 2004. This increase consisted of increases in costs related to network delivery of 251%, general and administrative of 26%, research and development costs of 45%, amortization of 75% and was partially offset by a reduction in sales and marketing expenses of 20%. The increase in network delivery costs was primarily due an increase in the number of transactions processed through our solution and the cost of installing lab servers into retail locations. General and administrative costs increased primarily due to the recognition for stock-based compensation in

the quarter. Research and development increased due to additional staffing and amortization from the purchase of new equipment and software. The decrease in sales and marketing was due to a reduction in consultants.

### FINANCIAL CAPABILITY

PhotoChannel's need for additional capital is primarily for working capital and equipment, as it expands its customer base. As per note 1 to the financial statements, the Company has capital requirements in excess of its currently available resources. The Company is dependent upon the proceeds of future funding to further finance the development and implementation of its business objectives.

Currently, the Company's operating expenses exceed its revenues, and there continues to be significant risk that sufficient revenues will not

be generated through the Network solution to sustain operations. The Company will need to raise funds from private and public equity or debt offerings in order to remain in business.

As at September 30, 2005, the Company had a working capital deficiency of \$588,066, compared to a positive working capital position of \$543,740 and \$388,277, at September 30, 2004 and 2003, respectively. As a company, which continues to strive for profitability, the Company's main source of funds has been, and will continue to be, the sale of equity capital until it manages to reach a cash flow positive position.

For the year ended September 30, 2005, the Company raised a total of \$2,111,559 of which \$1,848,509 was from the issuance of common shares and common share purchase warrants, \$245,450 was on exercise of common share purchase warrants and stock options and \$17,600 on the repayment of demand loans.

The Company began generating revenues in July 2001 through its Network solution. In September 2002, the Company, through its limited partnership signed its first large Canadian national photofinishing retailer. Throughout fiscal 2003 and 2004, the Company continued to sign on large Canadian retailers through its limited partnership and signed its first large photofinishing retailer in the United States in December 2003.

As stated in note 7 to the financial statements, the Company exercised its call options with the limited partners of the PhotoChannel LP in April 2004. This resulted in the Company reacquiring all of its rights under contracts entered into by the PhotoChannel LP with Canadian retailers.

During fiscal 2005, the Company continued to sign on additional photofinishing retailers to its online photofinishing solution.

#### **CHANGE IN ACCOUNTING POLICY**

The Company has a stock option plan, which is described in note 6 to the financial statements. 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. Previously, the company disclosed the pro forma effect of employee stock-based compensation expense in the notes to the financial statements.

As a result of adoption, the Company applied the recommendations with retroactive application and recorded an adjustment to opening deficit of \$314,011 and recognized a compensation expense of \$124,328 for stock options issued to employees for the year ended September 30, 2005.

#### **FUTURE ACCOUNTING CHANGES**

In January 2005, the Canadian Institute of Chartered Accountants ("CICA") released new Handbook Section 3855, "Financial Instruments - Recognition and Measurement", effective for annual and interim periods beginning on or after October 1, 2006. This new section prescribes when a financial instrument is to be recognized on the balance sheet and at what amount, sometimes using fair value and other times using cost-based measure. It also specifies how financial instrument gains and losses are to be presented and defines financial instruments to include accounts receivable and payable, loans, investments in debt and equity securities, and derivative contracts. The Company has not yet determined the impact of the adoption of this standard on its consolidated results of operations or financial position.

In September 2005, the CICA issued EIC 156, "Accounting by a Vendor for Consideration Given to a Customer (Including a Reseller of the Vendor's Products)" which will apply retroactively, with restatement of prior periods, to all interim and annual financial statements for fiscal years beginning on or after January 1, 2006. EIC 156 addresses the classification and accounting for sales and other incentives paid to

customers, such as discounts, coupons, rebates, free products or services, and co-operative advertising arrangements. The Company is currently assessing the impact of adopting this section on its financial results for the year ending September 30, 2006.

### **CRITICAL ACCOUNTING ESTIMATES**

PhotoChannel prepares its financial statements in accordance with GAAP. The preparation of consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Estimates are based upon historical experience and various other assumptions that are believed to be reasonable under the circumstances. These estimates are evaluated on an ongoing basis and form the basis for making judgments regarding the carrying values of assets and liabilities and the reported amount of revenues and expenses. Actual results may differ from these estimates under different assumptions.

### **REVENUE RECOGNITION**

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.

### **BUSINESS RISKS**

PhotoChannel is subject to various risks and uncertainties that can significantly affect its financial performance. Key risks include the following:

#### **MARKET AND COMPETITION**

There are inherent risks in the market for technological solutions. With the recent mass acceptance of the digital camera and camera cellular phone, the photography industry is quickly moving to employ an online technology, such as that offered by the Company. PhotoChannel's primary competition consists of very large, established corporations which can afford to meet the ever changing demands of this marketplace. To the extent that PhotoChannel cannot continue to raise the funds necessary to expand its market offering or to penetrate this market in a timely and cost effective manner, or achieve cost-effective pricing for its services, the Company's business growth could be adversely affected.

#### **CHANGES IN TECHNOLOGY**

The markets in which PhotoChannel operates are characterized by changing technology and evolving industry standards. The Company's ability to anticipate changes in technology, technical standards and service offerings is a significant factor in its ability to compete or expand into new markets. With limited experience in meeting customer requirements, there can be no assurance that the Company will be successful in continuing to identify, develop and market service offerings that will respond to technological change, evolving standards or individual customer standard and requirements.

#### **DEPENDENCE ON KEY PEOPLE**

PhotoChannel's growth and continued success depend on its ability to attract, retain, train and motivate highly skilled people. There can be significant competition for such people. There can be no assurance that the Company can retain its current key employees or attract and retain additional employees as needed. The loss of certain key employees could have an adverse impact upon the Company's growth, business and profitability.

## **POTENTIAL FOR LIABILITY**

There is a risk that the Company's systems may contain errors or defects or fail to perform. The Company currently contractually limits its liability for damages arising from its provision of services. While this is true of the vast majority of the Company's contracts today, such limitations of liability may not have been included in all of the Company's contractual arrangements in the past. Where such limitations have been included, there can be no assurance that they will be enforceable in all circumstances and will protect the Company from liability for damages. Furthermore, litigation regardless of contracts could result in substantial cost to the Company, divert management's attention and resources from the Company's operation, and result in negative publicity that may impair the Company's ongoing marketing efforts.

## **CURRENCY EXCHANGE RATE RISK**

The Company has customers in the U.S. and is therefore exposed to fluctuations in the value of the U.S. dollar against the Canadian dollar. At this time the Company's revenues and expenses in U.S. dollars largely offset each other, thereby creating a natural hedge, but the Company does not employ a hedge program. However, if there is a material change in circumstances and if the Company's expansion into the U.S. marketplace results in either a significant increase in revenues or expenses, then the level of the Company's risks to changes in the exchange rate could become important. Exchange differences are included in the statement of loss as they arise.

## **MANAGEMENT'S STATEMENT OF RESPONSIBILITY**

The consolidated financial statements contained in this report have been prepared by management in accordance with generally accepted accounting principles and have been approved by the Board of Directors. The integrity and objectivity of the consolidated financial statements are the responsibility of management. In addition, management is responsible for all other information in this report and for ensuring that this information is consistent, where appropriate, with the information contained in the consolidated financial statements.

Management maintains a system of internal accounting controls to provide reasonable assurance that the Company's assets are safeguarded and accounted for, and to facilitate the preparation of relevant, reliable, and timely financial information. Where necessary, management uses its best judgment to make estimates required to ensure fair and consistent presentation of this information.

The Company's management, including the Chief Executive Officer and Chief Financial Officer, believe that any disclosure controls and procedures or internal controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, they cannot provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been prevented or detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of a simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by unauthorized override of the control. The design of any systems of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Accordingly, because of the inherent limitations in a cost effective control system, misstatements due to error or fraud may occur and not be detected.

There has been no change in the Company's internal control over financial reporting during the Company's year ended September 30, 2005 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

The Board of Directors is responsible for ensuring that management fulfills its responsibilities for financial reporting and internal control, and exercises this responsibility principally through the Audit Committee. The Audit Committee includes four directors, three of whom are not involved in the daily operations of

the Company. The functions of the Audit Committee are to review the quarterly and annual consolidated financial statements; review the adequacy of the system of internal controls; review any relevant accounting, financial and security regulatory matters; and recommend the appointment of external auditors.

The external auditors, PricewaterhouseCoopers LLP, conduct an independent examination, in accordance with generally accepted auditing standards, and express their opinion on the consolidated financial statements. Their examination includes a review of the Company's system of internal controls and appropriate tests and procedures to provide reasonable assurance that the consolidated financial statements are, in all material respects, presented fairly and in accordance with generally accepted accounting principles in Canada. The external auditors have free and full access to the Audit Committee with respect to their findings concerning the fairness of financial reporting and the adequacy of internal controls.

#### **ADDITIONAL INFORMATION**

Additional information related to the Company can be found on SEDAR at [www.sedar.com](http://www.sedar.com).